Exploiting Regulatory Inconsistencies

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Exploiting Regulatory Inconsistencies

Emily Cauble*

Abstract

In many instances, sophisticated parties exploit inconsistencies between regulatory regimes to achieve beneficial treatment under each regime by obtaining classification under one regime that is, at least superficially, inconsistent with classification under the other regime. For instance, parties might design an instrument that is treated as “debt” for tax purposes, but “equity” for purposes of capital requirements instituted by financial regulators.

This Article asks whether exploiting regulatory inconsistencies is problematic. This Article concludes that inconsistency, in and of itself, is not necessarily a problem. Different regulatory regimes might classify a transaction differently when doing so best serves the unique goals of each regime. However, in other cases, inconsistency could be a byproduct of inaccurate classification by at least one regulatory regime. In such cases, the relevant regulator needs to reconsider its classification scheme.

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I. Introduction

In many instances, sophisticated parties exploit inconsistencies between regulatory regimes to achieve beneficial treatment under each regime by obtaining classification under one regime that is, at least superficially, inconsistent with classification under the other regime.¹ For instance, parties might exploit “economic substance inconsistency” (which occurs when “the same transaction receives different regulatory treatment in the future than it does today”). Id. In this Article, I examine only the first category of transactions because they may raise unique concerns. In particular, it is the only type of regulatory arbitrage in which sophisticated parties can obtain the best of both worlds—obtaining tax benefits and benefits under a non-tax regulatory regime by claiming inconsistent treatment across the two regimes. Because the ability of sophisticated parties to have their tax cake and their non-tax icing might strike some as particularly distasteful, it is worthwhile to analyze whether this particular inconsistency is problematic and consider what steps could be taken to address it when it is problematic.

¹ See infra Part II.A (presenting examples of transactions that are treated inconsistently by different regulatory regimes). Exploiting regulatory inconsistencies represents a subset of what Professor Fleischer labeled “regulatory arbitrage.” Victor Fleischer, Regulatory Arbitrage, 89 TEX. L. REV. 227, 244 (2010). Professor Fleischer defined regulatory arbitrage to include not only transactions in which parties exploit regulatory inconsistencies (which he labeled “regulatory regime inconsistency”), but also transactions in which parties exploit “economic substance inconsistency” (which occurs when “two transactions with identical cash flows receive different regulatory treatment under the same regulatory regime”) and transactions in which parties exploit “time inconsistency” (which occurs when “the same transaction receives different regulatory treatment in the future than it does today”). Id.
design an instrument that is treated as “debt” for tax purposes, but “equity” for purposes of state usury law (or, perhaps, “equity” for purposes of capital requirements instituted by financial regulators). Parties might engage in a transaction that allows recognition of losses for tax purposes, but does not require recognition of losses for bank regulatory purposes.

Intuitively, this type of behavior strikes many as disconcerting. Sophisticated parties are able to achieve the best of both worlds and avoid adverse treatment under multiple regulatory regimes by classifying a transaction differently for purposes of each regime. The inconsistencies inherent in these transactions are the features that may seem particularly vexing. We might assume that a sophisticated party would design a financial instrument to more closely resemble either debt or equity, according to which would lead to the most favorable overall outcome, taking into account all applicable regulatory regimes, business considerations, and other factors. However, if the instrument were designed so that it were “debt” for purposes of tax law, but “equity” for purposes of capital requirements imposed by bank regulators, we might be troubled by the sophisticated party’s ability to have their tax cake and their bank regulatory icing too, having achieved this outcome by taking positions that are, at least superficially, inconsistent.

Although planning by sophisticated parties may be troubling for a number of reasons, as this Article will argue, the inconsistency inherent in these transactions, in and of itself, is not

2. See infra Part II.A (discussing how a taxpayer might issue an instrument treated as debt for tax purposes and as equity for capital requirements purposes or state usury law purposes).

3. See infra notes 40–47 and accompanying text (recounting how during the 1980s savings and loan crisis, thrift institutions, holding suddenly devalued mortgages, swapped substantially similar bundles of interests in mortgages to report losses for tax purposes without needing to report the losses for regulatory purposes); see also Cottage Sav. Ass’n v. Comm’r, 499 U.S. 554, 556–57 (1991) (holding that a financial institution realizes tax-deductible losses when it swaps interests in a group of residential mortgage loans with other lenders).

4. See infra Parts II.A–B (providing examples of inconsistent treatment between regulatory schemes and explaining how such inconsistencies occur).

5. See infra Part II.B (pointing out multiple causes of such inconsistencies).

6. See infra Part III (explaining that tax planning may be problematic for a number of reasons).
necessarily problematic. Because different regulatory regimes might serve different purposes, classifying a transaction differently under each regime might not be a true inconsistency. In other words, something could be “debt” for tax purposes, but “equity” for state usury law purposes if the state usury laws have good reason to mean something different by “debt” than what is meant in the tax context. However, in some cases, inconsistency could be a byproduct of underlying failings in one or more of the regulatory regimes. For instance, the inconsistency in the preceding example would be problematic if state usury laws do not, in fact, have good reason to mean something different by “debt” than what is meant in the tax context.

In other words, inconsistent labels alone do not necessarily indicate that anything is amiss. Rather, each regulator must take care to ensure that a given transaction’s classification is correct under the regime that it administers, a fact which would be true even if the transaction were not treated inconsistently by another regime.

Exploitation of regulatory inconsistencies could also be problematic because it reduces “frictions” against tax planning. “Frictions” against tax planning are non-tax costs that a taxpayer must bear in order to obtain a more favorable tax outcome. Because of frictions, taxpayers will sometimes abandon attempts to structure their transactions to avoid adverse tax treatment if such structuring would result in undesirable accounting treatment, adverse non-tax regulatory treatment, or a sub-optimal

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7. *See infra* Part III (explaining how inconsistency may not be problematic when the different regimes serve different purposes).

8. *See infra* Part III (defining a “true inconsistency” as one between how the transaction is treated under one regime and how it should be treated); Jordan Barry, *On Regulatory Arbitrage*, 89 Tex. L. Rev. *See Also* 69, 75 (2010) (“The difference in treatment between regimes is an indicator that one of the regulatory regimes may be treating them inappropriately, but the difference in treatment is not a problem in and of itself.”).

9. *See infra* Part III (explaining that differing classifications between two regimes may be based on differing policy goals); Fleischer, *supra* note 1, at 244 (providing examples of diverging policy goals and how those impact the meaning given to the same terms by two different regulatory regimes).

10. *See infra* Part IV (explaining how incorrect classification under one or more regimes could lead to problematic inconsistencies in treatment).

11. *See infra* Part V.A (providing an overview of existing literature regarding “frictions” against tax planning).
business outcome. The ability of sophisticated parties to obtain favorably different treatment under multiple regulatory regimes can nullify the effects of otherwise potent frictions against tax planning. However, as this Article will argue, reliance on another regulatory regime as the source of friction could lead to arbitrary outcomes if the other regulatory regime classifies transactions in a manner unrelated to the goals of tax law. Such outcomes are not ideal.

An existing body of literature discusses both frictions against tax planning and the neutralization of those frictions by taxpayers’ ability to obtain inconsistent treatment across regulatory regimes. To the existing literature, this Article adds several key insights. First, this Article demonstrates that because of the structure of several tax doctrines, potential non-tax regulatory frictions against tax planning are not merely neutralized in some instances. Rather, obtaining a beneficial non-tax regulatory outcome can actually increase the chances of obtaining a beneficial tax outcome. Second, this Article argues that the usefulness of a non-tax regulatory regime as a friction will depend on whether the goals of the non-tax regulatory regime are aligned with the goals of tax law. Third, this Article provides examples to demonstrate the process that regulators might follow when determining whether inconsistent treatment is or is not appropriate in various cases.

12. See infra Part V.A (discussing the ability of frictions to inhibit tax planning).
13. See infra note 51 and accompanying text (discussing the “malleability” of a friction and its implications for taxpayer behavior).
14. See infra Part V.B (describing arbitrary outcomes that may arise).
15. See infra Part V.A (providing an overview of the existing literature on frictions).
16. See infra Part II.C (describing how, in some instances, obtaining a favorable outcome under a non-tax regime can increase the chances of obtaining a favorable tax outcome).
17. See infra Part II.C (describing how, in some instances, obtaining a favorable outcome under a non-tax regime can increase the chances of obtaining a favorable tax outcome).
18. See infra Part V.B (discussing the arbitrary outcomes that could arise if a non-tax regulatory regime with goals that diverged from the goals of tax law were used as a friction against tax planning).
19. See infra Part IV (describing instances in which inconsistent treatment is or is not appropriate).
This Article proceeds as follows. Part II provides examples of sophisticated parties obtaining beneficial, and seemingly inconsistent, treatment across regulatory regimes. It also illustrates how, in some cases, achieving a favorable non-tax regulatory result can heighten the odds of attaining a positive tax outcome. Part III presents the argument that inconsistency, in and of itself, may not be problematic because different regulatory regimes can serve different goals. Part IV illustrates how, in some cases, inconsistency could be a byproduct of a failing in one or more of the regulatory regimes. Finally, Part V addresses the effect of inconsistent treatment on frictions against tax planning.

II. Taxpayers Who Get the Best of Both Worlds

By treating a transaction differently for purposes of different regulatory regimes, a regulated party can potentially reap benefits under each regime. First, this Part will present examples of inconsistent treatment. Second, it will explain how inconsistency arises. Finally, as the existing literature on frictions recognizes, in many cases, parties utilize tax planning to obtain favorable tax outcomes despite seemingly inconsistent and favorable non-tax regulatory results. Subpart II.C will describe how, in some cases, parties obtain beneficial tax outcomes through planning because of the fact that they attained favorable non-tax regulatory results.

A. Examples of Inconsistent Treatment

A bank might issue a preferred stock instrument with enough debt-like features that it could be treated as “debt” for tax purposes, but “equity” for purposes of capital requirements instituted by financial regulators. This treatment, which would be inconsistent at least on its face, would provide the owners of the

\[ \text{See infra Part IIA (providing examples of inconsistent treatment in the context of classifying an instrument as debt or equity).} \]

\[ \text{See infra Part IIB (describing various causes of inconsistency).} \]

\[ \text{See infra Part IVA (discussing how the ability to obtain favorable outcomes under multiple regimes can nullify the effects of otherwise potent frictions against tax planning).} \]
bank’s common stock with the best of both worlds. 23 From a tax perspective, “debt” treatment is preferable to “equity” treatment, 24 and, from a capital requirements perspective, “equity” classification is superior to “debt” classification. 25

In terms of the tax outcome, if the instrument were considered debt for tax purposes, the bank would be entitled to deduct interest expense, but if the instrument were considered equity for tax purposes, the bank would not be entitled to any deduction for payments made on the instrument. 26 Therefore, debt treatment would be desirable because the interest deduction would reduce the bank’s tax burden. On the other hand, for purposes of bank capital requirements, equity classification is more advantageous than debt classification. A bank is required to maintain a minimum ratio of “tier one capital” to assets. 27 If the instrument were classified as equity for purposes of this requirement, the instrument might constitute “tier one capital,” and the bank could issue this instrument in lieu of issuing additional common stock. 28

23. See infra notes 26–29 and accompanying text (describing the advantages of classifying an instrument in this manner).

24. In most cases, debt treatment is more advantageous than equity treatment from a tax perspective. In some cases, however, a taxpayer could prefer equity treatment. For instance, assume a tax-exempt entity owned an instrument issued by an entity that was treated as a partnership for tax purposes. Assume the partnership engaged in activity that generated unrelated business taxable income. If the partnership is profitable, the tax-exempt entity may prefer that the instrument is classified as debt for tax purposes so that it earns interest income that is generally not subject to tax under the unrelated business income tax. If the partnership generates losses, then the tax-exempt entity may prefer for the instrument to be treated as equity for tax purposes so that it is allocated losses that it could deduct against other unrelated business taxable income. See I.R.C. § 512(c) (2012) (describing the tax treatment of a tax-exempt organization that is a partner in a partnership).

25. See infra notes 27–29 and accompanying text (describing the advantages of this classification).

26. See Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 4.01[2] (6th ed. 2000) (“Section 163(a) allows the payor corporation to deduct ‘all interest paid or accrued within the taxable year on indebtedness,’ but no comparable deduction is allowed for distributions to the corporation’s shareholders.” (quoting I.R.C. § 163(a) (2000))).

27. See Julie Andersen Hill, Bank Regulation by Enforcement: An Empirical Study, 87 Ind. L.J. 645, 650–51 (2012) (discussing requirements for banks, including the maintenance of minimum leverage ratios, calculated by “dividing tier 1 capital . . . by the bank’s total assets”).

28. See id. at 651 (defining tier one capital as “essentially common stock,
If the return on the preferred stock issued by the bank were limited and if the bank were sufficiently profitable, then the owners of the common stock would be better off than they would have been had the bank been required to issue additional common stock that would have diluted their return.  

Likewise, a corporation might issue an instrument treated as “debt” for tax purposes, but “equity” for purposes of state usury laws. From a tax standpoint, debt characterization is more favorable because it allows the corporation to benefit from an interest deduction. If the yield on the instrument would violate state usury laws, then equity characterization for usury law purposes would be more favorable because the instrument would not be subject to state usury laws.

B. How Inconsistency Arises

Sometimes, inconsistency across regulatory regimes might arise because one regime is more substance-based while the other is more form-driven. For instance, in some cases, state usury laws might adopt a form-driven approach, classifying instruments as debt or equity based on the labels assigned by the parties. At the same time, tax law employs a substance-based approach to classification that involves examining the economic features of an noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

29. See id. at 649 (explaining how banks can increase their stockholders return on equity by increasing their leverage).

30. See Jones Syndicate v. Comm’r, 23 F.2d 833, 835 (7th Cir. 1927) (concluding that “a taxpayer who borrows money at a usurious rate of interest and who, to conceal the usury, is compelled to execute a document which does not correctly describe the relationship of the parties, may, as against the government, disclose the true relationship of debtor and creditor”).

31. See supra note 26 and accompanying text (noting I.R.C. § 163(a) allows a tax deduction for interest).

32. See Jones Syndicate, 23 F.2d at 835 (discussing the interaction of equity characterization and state usury laws).

33. See Barry, supra note 8, at 73 (“[R]egulatory arbitrage is a phenomenon that follows from having regulations that fail to take economic reality into account.”).

34. See infra note 109 and accompanying text (positing that this form-driven approach was at work in both Jones Syndicate and Commissioner v. Bollinger).
instrument and other factors. Therefore, tax-usury law inconsistency could arise if an instrument were labeled “equity,” but had debt-like economic features.

In other cases, inconsistency could arise even when both regimes are substance-based. This could occur because the regimes prioritize different factors or because factors that were relevant for purposes of one could be irrelevant for purposes of the other. For instance, as discussed below, a substance-based classification scheme for state usury law purposes might focus mainly on the extent to which the holder of the instrument has a claim that was subordinate to the claims held by others. The substance-based classification scheme used for tax purposes takes into account subordination, but also examines many other factors.

Sometimes, inconsistent treatment is actively encouraged by one of the regulators. For example, during the 1980s savings and loan crisis, a number of thrift institutions held mortgages that had...

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35. See infra Part IV.A (cataloguing the substantive factors that may be considered).

36. See infra Part IV.B (suggesting that even when both regimes are substance-based, the relevant substance might not be the same under both regimes).

37. See infra Part IV.B (asserting that for purposes of a state usury law regime that examined substance, a claim subordinated to all other claims would be considered equity).

38. See infra Parts IV.A–B (listing additional factors relevant to the tax classification of an instrument as debt or equity).

39. Sometimes, inconsistent treatment also arises as a result of lobbying of the regulators by the regulated parties. See, e.g., David M. Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312, 1338 n.85 (2001)

[B]anks petitioned the Federal Reserve to designate so called trust-preferred securities as “tier one” capital. These securities were eligible for a tax deduction, but their debt-like features rendered them, at least initially, an insufficiently reliable source of core capital for regulated banks. Eventually, though, the Federal Reserve relaxed its standards enough to offer these securities a “tier one” designation.

The classification of trust preferred securities as “tier one” capital, however, has been phased out by the Dodd-Frank Wall Street Reform and Consumer Protection Act. See, e.g., Candemir Baltali & Joseph Tanega, Basel III: Dehybridization of Capital, 8 N.Y.U. J. L. & BUS. 1, 43 (2011) (“Given Dodd-Frank Act’s § 171, neither trust preferred securities nor cumulative perpetual preferred stock would qualify for inclusion as tier 1 capital among the top 50 [bank holding companies].”).
fallen drastically in value. The thrift institutions had issued the loans at low, fixed interest rates, and market interest rates had risen substantially. As a result, the loans had declined in value significantly. The thrift institutions would benefit from realizing the resulting losses for tax purposes, because doing so would allow the institutions to deduct the losses, lowering their taxable income and tax liability. However, reporting the losses for accounting purposes (rather than continuing to report the loans as worth their original value) could result in many of the thrift institutions being subject to closure by the Federal Home Loan Bank Board. In order to enable the institutions to realize the losses for tax purposes, the Federal Home Loan Bank Board issued a memorandum describing a way in which thrift institutions could swap substantially similar bundles of interests in mortgages without being required to report the losses for regulatory purposes. Thrift institutions engaged in the swaps and reported the losses for tax purposes. The IRS challenged the losses claimed by one of the institutions, and the Supreme Court held that the losses were realized for tax purposes.

Sometimes, inconsistent treatment might arise not because the regulatory regimes lead to different outcomes, but because one or more of the regimes is under-enforced. That is, parties sometimes might claim inconsistent treatment in cases in which their claim could be successfully challenged under one or more of the regimes, if the regulator or regulators enforced the relevant requirements.

41. Id.
42. Id.
43. Id.
44. Id. at 557.
45. See id. at 557 (“The FHLBB's acknowledged purpose for Memorandum R-49 was to facilitate transactions that would generate tax losses but that would not substantially affect the economic position of the transacting S & L's.”).
46. Id. at 557–58.
47. Id. at 558.
C. Rather than Limiting Tax Planning, Efforts to Obtain Favorable Non-Tax Regulatory Outcomes Sometimes Facilitate Tax Planning

As discussed below, others have noted that, in some cases, taxpayers’ aims to achieve favorable results under non-tax regulatory regimes can serve as “frictions” against tax planning.48 “Frictions” against tax planning are non-tax costs that a taxpayer must bear in order to obtain a more favorable tax outcome.49 Because of such frictions, taxpayers will sometimes abandon attempts to structure their transactions to avoid adverse tax treatment if such structuring would result in undesirable accounting treatment, adverse non-tax regulatory treatment, or a sub-optimal business outcome.50

The ability of sophisticated parties to simultaneously obtain favorable treatment under multiple regulatory regimes can nullify the effects of otherwise potent frictions against tax planning.51 In fact, the state of affairs is even more favorable to taxpayers in some cases. In particular, because of the structure of various tax rules, in some cases the potential “friction” role of a non-tax regulatory regime is not merely nullified—rather obtaining a favorable result under a non-tax regime can grease the wheels of tax planning. That is, obtaining a favorable non-tax outcome actually increases the chances of obtaining a favorable tax outcome.

48. Infra Part V.A.
49. Id.
50. Id.
51. See, e.g., Fleischer, supra note 1, at 244–47 (describing “regulatory regime inconsistency”); Schizer, supra note 39, at 1324

[The “malleability” of a friction—is often crucial. For example, corporate taxpayers often care about the earnings reported to shareholders, so financial accounting is a “strong” friction. To maintain impressive reported earnings, corporate managers may well abandon a transaction that offers a tax benefit but also would depress earnings. Issuance of a simple debt security, for instance, creates interest expense that is tax deductible but also would reduce earnings. But what if the best of both worlds is available? Can the deal be tweaked so the expense no longer depresses accounting earnings, but still generates a tax deduction? If so, the accounting friction is malleable and will not stop the tax planning.
To illustrate this, consider the Non-Disavowal Doctrine.\textsuperscript{52} In tax cases, the genuine substance of a transaction will often triumph over the transaction’s mere form for purposes of determining the transaction’s tax consequences.\textsuperscript{53} Despite this principle, a taxpayer often will be bound to the transactional form that he or she selects.\textsuperscript{54} Courts’ rejection of taxpayers’ attempts to

\textsuperscript{52} See Robert Thornton Smith, \textit{Substance and Form: A Taxpayer’s Right to Assert the Priority of Substance}, 44 TAX LAW. 137, 138 (1990) (defining the Non-Disavowal Principle as “the classic statement that a taxpayer may not assert the substance over form principle”); see also Kenneth L. Harris, \textit{Should There Be a “Form Consistency” Requirement? Danielson Revisited}, 78 TAXES 88, 89 (2000) (referring to the “fundamental notion” that where the taxpayer controls the facts, the taxpayer is restricted in its “ability to assert the substance and not the form controls for tax purposes” as the “Taxpayer Non-Disavowal Principle”). Another example would be the way in which attaining a favorable non-tax regulatory outcome can serve the role of demonstrating “business purpose” under the economic substance doctrine. See, e.g., Leandra Lederman, \textit{W(h)ither Economic Substance?}, 95 IOWA L. REV. 389, 433 (2010) [hereinafter Lederman, Economic Substance] (“[N]on-tax regulatory requirements seem to provide a business purpose, even if the regulator condones a way to evade those requirements.”).

\textsuperscript{53} See, e.g., Michael E. Baillif, \textit{The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate}, 48 TAX LAW. 289, 289 (1995) (“A fundamental principle of income tax law is that taxation should be based upon the substance, not the form, of a transaction.”); J. Bruce Donaldson, \textit{When Substance Over Form Argument Is Available to the Taxpayer}, 48 MARQ. L. REV. 41, 41 (1964) (“The gospel that the substance of a transaction, rather than mere form, controls the tax incidents is accepted by all.”); Harris, supra note 52, at 89 (“It is a fundamental principle of federal income taxation that the tax consequences of a transaction turn on the ‘substance’ and not the ‘form’ of the transaction.”); Smith, supra note 52, at 137 (“A fundamental principle of . . . tax law is that taxation should be based upon the substance, and not the form, of transactions.”). A complete discussion of substance-over-form in tax law is beyond the scope of this Article. For some further discussion on this topic, see Joseph Isenbergh, \textit{Musings on Form and Substance in Taxation}, 49 U. CHI. L. REV. 858, 863–80 (1982); Jeffrey L. Kwall & Kristina Maynard, \textit{Dethroning King Enterprises}, 58 TAX LAW. 1, 11–15 (2004); Joshua D. Rosenberg, \textit{Tax Avoidance and Income Measurement}, 87 MICH. L. REV. 386–87, 435–39 (1988); Lewis R. Steinberg, \textit{Form, Substance, and Directionality in Subchapter C}, 52 TAX LAW. 457, 457–88 (1999).

\textsuperscript{54} See, e.g., Baillif, supra note 53, at 289 (“Although the Service is routinely granted the right to look beyond the form of a transaction or its label on a tax return, a taxpayer’s right to assert the same privilege is, at best, uncertain.”); William S. Blatt, \textit{Lost on a One-Way Street: The Taxpayer’s Ability to Disavow Form}, 70 OR. L. REV. 381, 384 (1991) (“The principle that the government alone may appeal to the substance of a transaction pervades federal tax law. Every taxpayer seeking to disavow the form of a transaction must consider the possibility that substance arguments create a one-way street in favor of the government.”); Donaldson, supra note 53, at 42
invoke the substance-over-form doctrine has been referred to as the “Non-Disavowal Doctrine.” Notwithstanding the Non-Disavowal Doctrine, taxpayers do not always lose when they assert the rule of substance-over-form. Oftentimes, prevailing taxpayers in such cases are able to provide a non-tax explanation for the form they selected. Thus, for these taxpayers, a favorable non-tax outcome increases the chances of a good tax outcome.

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A considerable body of thought exists that the doctrine of substance is a sword available to the Commissioner, but that it may not be used as a shield by the taxpayer. While this homely bit of wisdom has much present currency, it is not wholly accurate as a matter of over-all case analysis.

Harris, supra note 52, at 89 (“There is also a fundamental notion that where the taxpayer, and not the government controls the facts, the taxpayer should be restricted in its ability to assert that the substance and not the form controls for tax purposes . . . .”); Nickolas J. Kyser, Substance, Form, and Strong Proof, 11 AM. J. TAX POL’Y 125, 125–26 (1994)

The notion that tax consequences should flow from the substance rather than the form of transactions has been accepted by most courts. As one might expect, the courts have been rather skeptical about the use of this idea by taxpayers, who were in position to control the original form of the transaction and whose protestations that something else was intended are likely to be affected by the selectiveness of self-interested memory.

Smith, supra note 52, at 137

The Commissioner clearly is entitled to invoke [the notion that substance prevails over form], but a taxpayer’s right to do so is problematic. At times, the courts have accepted a taxpayer’s assertion of the priority of substance. At other times, however, they have concluded that a taxpayer is bound by the form of his transaction.

55. See, e.g., Harris, supra note 52, at 89 (referring to this concept as the “Taxpayer Non-Disavowal Principle”); Smith, supra note 52, at 138 (referring to this concept as the “Non-Disavowal Principle”).

56. See infra notes 78–80 and accompanying text; see also Emily Cauble, Reforming the Non-Disavowal Doctrine, 35 VA. TAX REV. 439, 441–42 (2016) (explaining that taxpayers have more success when providing a “non-tax explanation” for the selected form).

57. See infra notes 78–80 and accompanying text; see also Cauble, supra note 56, at 441–42 (explaining that taxpayers have more success when providing a “non-tax explanation” for the selected form); Comm’r v. Proctor Shop, 82 F.2d 792, 794 (9th Cir. 1936) (providing non-tax reason for selected form and succeeding on claim).

58. See Comm’r v. Proctor Shop, 82 F.2d 792, 794 (9th Cir. 1936) (providing non-tax reason for selected form and succeeding on claim).
In order to illustrate the Non-Disavowal Doctrine, consider the facts and holding of *Maletis v. United States.* In *Maletis,* the taxpayer established an entity to operate a wine-making business. In form, the entity was owned by the taxpayer and his two sons because paperwork had been filed with the IRS and state authorities indicating that the entity was owned by the three individuals and that all three had made contributions to the entity. In substance, the entity was owned only by the taxpayer. His sons had not, in fact, made the claimed contributions to the entity and, apparently, had no real involvement in the business.

In years when the business was profitable, the taxpayer filed tax returns in accordance with the form of the arrangement (in other words, the tax returns were consistent with the entity being a partnership owned by three individuals). As a result, in years in which the business generated taxable income, that income was reported in part by the taxpayer and in part by his sons. This reporting led to less total tax liability than if all taxable income had been reported by the taxpayer presumably because the sons were subject to lower effective tax rates than the taxpayer.

In a subsequent year in which the business generated a loss, the taxpayer claimed that in substance the business was owned entirely by him and not by a partnership in which his sons were partners. As a result, the taxpayer asserted the right to deduct the entire tax loss, leading to lower overall tax liability than what would have resulted had the tax loss been shared among the taxpayer and his sons, given his sons’ lower effective tax rates. The IRS challenged this treatment asserting that the taxpayer should be bound by the form he previously selected: that of a

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59. *Maletis v. United States,* 200 F.2d 97 (9th Cir. 1952).
60. *Id.* at 97–98.
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.*
partnership. The court held in favor of the IRS. Thus, the taxpayer was prevented from disavowing the form he selected and was required to report tax consequences based on form rather than substance.

Describing the rationale for the Non-Disavowal Doctrine, the court stated that without such a rule, “the taxpayer could commence doing business as a corporation or partnership, and, if everything [went] well, realize the income tax advantages therefrom; but if things [did] not turn out so well, [could] turn around and disclaim the business form he created to realize the loss as his individual loss.” In other words, one goal of the Non-Disavowal Doctrine is to prevent “post-transactional tax planning.”

A taxpayer who engages in “post-transactional tax planning” structures a transaction so that he or she may report based either on form or on substance, whichever would lead to more favorable tax consequences, once the results of the transaction are known. In Maletis, for instance, if the business generated gains, the taxpayer would report the results based on form because doing so resulted in lower aggregate tax liability, but if the business

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69. Id.
70. Id.
71. Id.
72. Id.
73. For further discussion, see Bailiff, supra note 53, at 298 (“[S]ome courts fear that permitting a taxpayer to disavow her own form might invite that taxpayer to engage in post-transactional tax planning. They worry that a taxpayer may decide alternatively to support or impeach a form based upon her post-transactional determination of the resultant tax liability . . . .”); Cauble, supra note 56, at 460–71 (“[T]he Non Disavowal Doctrine appears to be intended to address the possibility that taxpayers could intentionally engage in transactions whose form differed from their substance to leave themselves the option of engaging in Post-transactional Tax Planning once the results of the transaction were known.”); Harris, supra note 52, at 97 (“[C]oncerns about post transactional tax planning . . . arise in situations where the taxpayer challenging the form . . . proceeds to assert substance-over-form only after tax audit.”); Smith, supra note 52, at 144 (“Some cases reflect the concern that permitting a taxpayer to disavow its own form might entitle a taxpayer to engage in post-transactional tax planning and, depending upon his tax circumstance, support or impeach form.”).
74. See Cauble, supra note 56, at 442–43 (discussing post-transactional tax planning).
generated losses, the taxpayer would report the results based on substance in order to obtain lower aggregate tax liability.\textsuperscript{75}

In some cases, taxpayers successfully report based on substance rather than form, notwithstanding the Non-Disavowal Doctrine.\textsuperscript{76} Oftentimes, in a case in which the taxpayer prevails, the taxpayer can provide a non-tax explanation for why the taxpayer adopted a form that was different from the transaction's substance.\textsuperscript{77} In one example, the taxpayer labeled an instrument “equity,” even though its substantive features were debt-like, in order to avoid violating state usury laws.\textsuperscript{78} In another, the taxpayer labeled an instrument “equity,” even though it had debt-like substantive features, to avoid an adverse effect on the credit rating of the corporation that issued the instrument.\textsuperscript{79}

\begin{footnotesize}
\begin{enumerate}
\item See Maletis v. United States, 200 F.2d 97, 98–99 (9th Cir. 1952) (discussing how the taxpayer obtained a tax benefit in the early years by treating the entity as a partnership and, in the later years, the taxpayer sought to treat the venture as if it were not a partnership).
\item See, e.g., Cauble, supra note 56, at 450–52 (discussing cases in which taxpayers have successfully asserted substance-over-form, notwithstanding the Non-Disavowal Doctrine).
\item In some cases, taxpayers’ attempts to assert that substance should prevail over form succeed even though the taxpayer cannot provide a non-tax explanation for the form selected. For an overview of the case law, see, for example, Blatt, supra note 54, at 427–38.
\item See Jones Syndicate v. Comm’r, 23 F.2d 833, 834 (7th Cir. 1927) (“[T]he witnesses who testified . . . described the transaction as a loan and stated that the parties made use of the so-called first preferred stock as a mere expedient to circumvent the force and effect of the usury laws.”).
\item See Comm’r v. Proctor Shop, 82 F.2d 792, 792 (9th Cir. 1936) Aaron Holtz was willing to lend the necessary funds to the contemplated organization, but was not willing to accept stock because he desired to be assured that his advance would be repaid, and he also wanted a definite income from the funds. It was deemed inadvisable to issue bonds to cover the loans, as that would affect the credit of the corporation.
\end{enumerate}
\end{footnotesize}

For other cases in which taxpayers win and can provide a non-tax explanation for the form that they selected, see, e.g., United States v. Title Guarantee & Tr. Co., 133 F.2d 990, 992–96 (6th Cir. 1943) (holding that payments made on “preferred stock” could be treated as deductible interest when the company issued “preferred stock” with some debt-like features rather than an instrument labeled “debt” with even more debt-like features in order to avoid an adverse effect on the company’s creditworthiness); E.C. Gatlin v. Comm’r, 34 B.T.A. 50, 56 (1936) (“We therefore conclude that a taxpayer who borrows money at a usurious rate of interest and [who], to conceal the usury, is compelled to execute a document which does not correctly describe the relationship of the parties, may, as against the government,
both of these cases, the taxpayers prevailed in reporting the consequences of the transaction as if the instrument were debt for tax purposes.80

At first glance, it may seem odd that courts are more likely to allow a taxpayer to obtain more beneficial tax consequences by disavowing the form he or she selected if the form produced non-tax benefits. However, this feature of law could be explained as an attempt by courts to identify taxpayers who are not engaged in “post-transactional tax planning” and allow those taxpayers to disavow their selected forms.81 If a taxpayer engages in a transaction and selects a form that differs from the transaction’s substance, the taxpayer’s choice of form might generally suggest that the taxpayer planned to leave open the option of engaging in “post-transactional tax planning” by reporting the tax consequences of the transaction based on either its form or its substance, whichever, in hindsight, led to more favorable tax consequences.82 If a given form was selected instead to produce...
some non-tax benefits (for instance, if an instrument was labeled “equity” to avoid state usury laws) that provides an alternative explanation for the taxpayer’s chosen form, and the alternative explanation might help to rebut the presumption that the taxpayer selected a transactional form in order to facilitate “post-transactional tax planning.”

This line of reasoning is not entirely illogical. However, this method of analysis will fail in many cases to accurately distinguish between taxpayers who are engaging in “post-transactional tax planning” and taxpayers who are not. As a result, some taxpayers who are engaging in “post-transactional tax planning,” or who did structure their transactions to facilitate “post-transactional tax planning,” will, successfully disavow their selected forms. This is true because a taxpayer could have multiple motives for selecting a given form. For example, a taxpayer could label an instrument that has debt-like features “equity” not only in order to avoid state usury laws, but also to enable “post-transactional tax planning.”

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83. Id.

84. This approach can also result in holding some taxpayers to their selected forms even when they did not engage in and had no intention to engage in post-transactional tax planning. For further discussion, see Cauble, supra note 56, at 474–75

Some taxpayers may select a given form that differed from a transaction’s substance merely because they did not give adequate thought to the resulting tax consequences and did not seek tax advice at the time they selected the form. For instance, a taxpayer might hold an instrument that has debt-like features but label the instrument “equity” in various documents merely because the taxpayer did not evaluate the tax consequences of doing so. It is possible that this taxpayer had no plans to engage in Post-Transaction Tax Planning and would have reported the tax consequences as if the instrument was debt (because it is debt in substance) regardless of the transaction’s economic outcome . . . . Nevertheless, if this taxpayer characterizes the instrument as debt for tax reporting purposes in a year in which equity treatment would lead to more tax liability, the Service can challenge the taxpayer’s reporting based on the Non-Disavowal Doctrine. Assuming the taxpayer has no non-tax explanation to offer for the “equity” label that the taxpayer used, the taxpayer would likely lose.

85. For further discussion and a proposal for reform, see Cauble, supra note 56, at 475–81 (explaining how a taxpayer could be engaging in post-transactional tax planning despite the fact that the taxpayer can offer a non-tax explanation for his or her selected form and proposing a new method of analysis for courts to use).
As another illustration of how a non-tax explanation could facilitate tax planning, imagine the facts of *Maletis*, but with a couple modifications. Assume that the taxpayer adopted the partnership form in order to obtain some non-tax benefit (perhaps it allowed borrowing at a rate that would have violated state usury laws if the loan were made to an individual rather than a partnership). Also assume that the venture proved to be unsuccessful for many years so that, in all years to date, the taxpayer has reported the losses as his own (based on the substance of the arrangement). Because this taxpayer can offer a non-tax explanation for the form selected, the Non-Disavowal Doctrine will not prevent this taxpayer from reporting the consequences as if the arrangement were owned solely by the taxpayer (disavowing the partnership form selected). This is true notwithstanding the fact that this taxpayer may have intended to engage in “post-transactional tax planning” (if the venture had been successful and generated taxable income, the taxpayer may have reported the results as if the venture were owned by a partnership). For taxpayers such as this, non-tax regulatory regimes do not act as a friction against tax planning. On the contrary, the ability to offer a non-tax explanation for a taxpayer’s selected form greases the tax planning wheels.

86. One might argue that, in such a case, there is no reason not to allow the taxpayer to disavow the selected form. Unlike in the actual *Maletis* case, the taxpayer never reported the results based on form. Therefore, the taxpayer is not attempting to whipsaw the IRS by reporting based on substance after having already reported based on form in years that are closed by the statute of limitations. However, invoking the Non-Disavowal Doctrine might still be warranted in this case if the taxpayer planned to report based on form in years when the business was profitable, but the taxpayer simply has not had a chance to do so because the venture has not generated taxable income. Invoking the Non-Disavowal Doctrine in such a case could be described as a penalty intended to discourage taxpayers from structuring transactions so that form differed from substance to enable post-transactional tax planning.

87. If the taxpayer did report the results as if the venture was owned by a partnership, the IRS could successfully challenge this claim based on the substance-over-form doctrine. See supra note 53 and accompanying text (discussing the substance-over-form doctrine). However, the IRS might not audit this particular taxpayer, and in such a case, the taxpayer’s claim would proceed unchallenged.

88. See infra Part V.A (discussing the existing literature regarding frictions against tax planning).
III. Inconsistency is not Necessarily Inconsistency

Tax planning—taxpayers re-arranging their transactions and other behavior to obtain more favorable tax outcomes—potentially leads to a number of adverse consequences, at least when it is not the type of planning that tax provisions are explicitly designed to encourage.89 In particular, when sophisticated parties structure their transactions to obtain more beneficial tax outcomes, that behavior erodes tax revenue.90 In addition, tax planning perpetuates unfairness when sophisticated parties achieve more favorable tax outcomes than less sophisticated taxpayers.91 It also contributes to the perception that the tax system is unfair, which can, in turn, undermine voluntary tax compliance.92 Finally, tax

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89. If the planning is what Congress intended, then it is not abusive and possibly is valuable, if the behavior encouraged by the particular tax provision is valuable. See, e.g., Lederman, Economic Substance, supra note 52, at 395–96

If measuring income without altering taxpayer behavior were the only thing Congress sought to accomplish with the federal income tax system, then, in theory, any tax-motivated action could be considered inconsistent with the goal of the tax system . . . . However, it is well known that the federal income tax system does not try only to measure taxpayers’ taxable income. It also contains provisions expressly designed to alter taxpayers’ behavior. These latter provisions intentionally mismeasure income in order to induce more of a particular activity. For example, the individual retirement account provisions encourage people to save money for their retirement. More generally, certain transactions may only be profitable after taxes and may thus be undertaken because of the tax subsidy the government offers. Taking the government up on proffered tax benefits is, by definition, not abusive.

90. See, e.g., Schizer, supra note 39, at 1319 (“The reasons for curtailing tax planning are familiar and can be stated briefly. Obviously, more revenue is collected, so the government is funded without need for other taxes that are less appealing.”).

91. See, e.g., id. (“The reasons for curtailing tax planning are familiar and can be stated briefly . . . . Since wealthy and well advised taxpayers have an edge in planning, limiting this advantage can lead to a more equitable distribution of tax burdens.”).

92. See, e.g., Michael S. Knoll, Tax Planning, Effective Marginal Tax Rates, and the Structure of the Income Tax, 54 Tax L. Rev. 555, 555 (2001) (“The specter of wealthy individuals and large corporations hiring legions of high-priced lawyers and accountants to develop and implement tax saving strategies creates the perception that the system is unfair.”); Leandra Lederman, The Interplay Between Norms and Enforcement in Tax Compliance, 64 Ohio St. L.J. 1453, 1476–78 (2003) (discussing the effects of perceptions of fairness on tax compliance); Schizer, supra note 39, at 1319 (“Since wealthy and well advised taxpayers have
planning potentially creates inefficiency and wastes societal resources.93

These ramifications of tax planning exist even in cases that do not involve exploiting regulatory inconsistencies. To address the question of whether something should be done to prevent exploiting regulatory inconsistencies, we should address the question of whether inconsistency, in and of itself, is particularly problematic.

If the two regulatory regimes serve different purposes, the perceived inconsistency is not troubling because it is not true inconsistency. The parties are not, for instance, representing different facts to different regulators. The regulators view the same facts through their respective lenses and reach different conclusions because they are focused on classifications with different criteria.94 For example, something could be “debt” for tax

an edge in planning, limiting this advantage can lead to a more equitable distribution of tax burdens. The average taxpayer’s faith in the system is preserved, promoting voluntary compliance and the attendant savings in enforcement costs.

93. See Heather M. Field, Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System, 47 HARV. J. ON LEGIS. 21, 23 (2010) (“Scholars generally conclude that the ability of taxpayers to select their tax treatment by arranging their business affairs in particular ways is detrimental to societal welfare . . . .”); Knoll, supra note 92, at 555 (“Tax planning not only creates harmful perceptions, it also is frequently harmful in its own right . . . . [T]ax planning leads taxpayers to invest in many projects that they would not undertake solely on the economics.”); Schizer, supra note 39, at 1319 (stating that limiting tax planning reduces “social waste . . . as taxpayers refrain from tax motivated behavior”); David A. Weisbach, Line Drawing, Doctrine, and Efficiency in Tax Law, 84 CORNELL L. REV. 1627, 1632 (1999) [hereinafter Weisbach, Line Drawing] (“Taxing similar activities differently causes behavioral distortions . . . .”). Additionally, scholars have observed that tax planning is wasteful because the time and resources devoted to tax planning could be put to better, more productive uses. See, e.g., Knoll, supra note 92, at 555–56 (“From a societal standpoint, it would be better simply to reduce taxes and redeploy the time and talent devoted to tax planning to other more productive pursuits.”); David A. Weisbach, Ten Truths About Tax Shelters, 55 TAX L. REV. 215, 222 (2002) [hereinafter Weisbach, Ten Truths] (“Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses. No new medicines are found, computer chips designed, or homeless housed through tax planning.”).

94. For similar discussion, see Barry, supra note 8, at 75 (“The difference in treatment between regimes is an indicator that one of the regulatory regimes may be treating them inappropriately, but the difference in treatment is not a problem in and of itself.”); Fleischer, supra note 1, at 244
purposes, but “equity” for state usury law purposes if the state usury laws have good reason to mean something different by “debt” than what is meant in the tax context. If the regimes serve different goals, then to avoid a true inconsistency (meaning inconsistency between how the transaction is treated under one of the regimes and how it should be treated under that regime), it might be necessary to classify a transaction differently for purposes of each regime.

One might respond that inconsistent treatment compounds the problems associated with run-of-the-mill tax planning (in other words, tax planning that does not involve inconsistent treatment) by making tax planning easier. In particular, by claiming inconsistent treatment, a sophisticated party can obtain a favorable tax outcome without sacrificing his or her non-tax regulatory goals. In other words, claiming inconsistent treatment nullifies a potential friction, a concern that is addressed in Part V below.

One might also respond that inconsistent treatment compounds the typical tax planning problems by further perpetuating unfairness because the inconsistent treatment heightens the advantages gained by sophisticated parties. Not only can sophisticated parties obtain better tax outcomes than others, but they can also obtain more favorable non-tax regulatory outcomes at the same time. However, if the non-tax regulatory regime has goals that are entirely unrelated to the goals of tax law, this concern may be misplaced. A party who obtains a favorable tax outcome via planning may have benefited from a number of fortunate circumstances in any number of areas of life, and

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Doctrinal inconsistency is not always a mistake caused by inept legislative drafting. Different regulators may have different policy goals in mind. It may be important for securities regulators, who seek to protect investors, to define the meaning of “security,” “dealer,” or “sale” in a way that differs from the taxing authorities, who seek to raise money for the public fisc.

Grace Soyon Lee, What's In a Name?: The Role of Danielson in the Taxation of Credit Card Securitizations, 62 BAYLOR L. REV. 110, 162–65 (2010) (discussing how, in the context of credit card securitization, tax treatment and accounting treatment may differ because accounting rules have different goals than tax rules).

95. See supra Part II.B (discussing potential causes of inconsistencies between an instrument’s tax classification and its classification for purposes of state usury laws).
obtaining a favorable non-tax regulatory outcome is not, in principle, any different from those other fortunate circumstances. In other words, to argue that someone is less deserving of a favorable tax outcome because he or she obtained a favorable state usury law outcome would seem to be equivalent to arguing that a person is less deserving of a favorable tax outcome because he or she benefits from good health.

IV. Inconsistency as a Byproduct of Inaccuracy

Although inconsistent treatment across regulatory regimes, in and of itself, might not be a problem, in some cases, the inconsistency could result from incorrect classification under one or more of the regimes. Because this Part makes use of examples involving the classification of instruments as debt or equity, it will begin by describing how tax law classifies instruments. Then, it will discuss whether and when inconsistency between tax classification and state usury law classification is acceptable. Finally, it will evaluate the appropriateness of inconsistency between tax characterization and categorization for purposes of capital requirements.

A. Debt Versus Equity in Tax Law

Based on existing doctrine, an instrument will be treated as debt for tax purposes only if the parties intend for the holder of the instrument to have a definite right to be repaid a fixed amount at a certain time, regardless of the income of the obligor. To

96. See, e.g., Bauer v. Comm’r, 748 F.2d 1365, 1367–68 (9th Cir. 1984)

The determination of whether an advance is debt or equity depends on the distinction between a creditor who seeks a definite obligation that is payable in any event, and a shareholder who seeks to make an investment and to share in the profits and risks of loss in the venture.

Tomlinson v. 1661 Corp., 377 F.2d 291, 295 (5th Cir. 1967)

The term “indebtedness” implies an existing unconditional and legally enforceable obligation to pay . . . . Generally, these criteria are designed to disclose the real nature of the transaction in question—that is whether it exhibits the characteristics of a bona-fide loan to the corporation which is expected, indeed, may be compelled, to be repaid in full at some future date, or whether as a formalized attempt to
determine the parties' intent, courts examine underlying substantive factors rather than merely relying on the parties' label for the instrument. Assume, for instance, that the holder of a given instrument has provided an advance to a corporation. Substantive factors in the case of the advance to the corporation could include, among others: (1) whether the corporation has made an unconditional promise to pay a fixed amount to the holder of the instrument, (2) whether the holder of the instrument has a legal right to enforce payment, (3) whether the instrument has a long or short term to maturity, (4) whether the corporation is thinly capitalized (in other words, whether it has a high ratio of debt to equity), (5) the liquidity of the corporation's assets, (6) the stability of the corporation's revenues, (7) subordination of the instrument to other creditors, and (8) whether the instrument that is claimed to be "debt" is held by the owners of the equity of the corporation and, if so, whether the "debt" is held in the same proportion as the proportion in which the owners hold the equity.

These factors can be grouped into three general categories. First, a court might use some of the factors to verify, as a threshold matter, that the holder of the instrument has a legal right to receive definite payment. Factors (1) and (2) assist a court in making this determination, which is relevant to the ultimate question the court must answer: whether the parties intend for the

achieve the desired tax result while lacking in necessary substance, it merely parades under the false colors of such a transaction.

John Lizak, Inc. v. Comm'r, 28 T.C.M. (CCH) 804, 807 (1969) ("It has often been recognized that 'the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event.'"); see also William T. Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369, 404–05 (1970–71) (quoting and citing to cases that have described the distinction between debt and equity in a similar manner).

97. See Bauer, 748 F.2d at 1367–68 ("The outward form of the transaction is not controlling; rather, characterization depends on the taxpayer's actual intent, as evidenced by the circumstances and conditions of the advance.").

98. See Plumb, supra note 96, at 411–12 (compiling and categorizing a list of factors upon which courts have relied).

99. See Plumb, supra note 96, at 411–12 (conceptualizing this category as factors "involving the formal rights and remedies of creditors as distinguished from stockholders").
holder of the instrument to have a definite right to be repaid a fixed amount at a certain time, regardless of the income of the obligor.

Second, some of the factors are aimed at determining whether or not the advance could be repaid. In other words, some are utilized to assess the instrument’s risk. Factors (3) through (7) provide information relevant to assessing risk, or the corporation’s ability to make payments when due. Although courts do not always view the world in this way, if the relevant factors suggest that an instrument is very risky, such an assessment could undercut a determination that the holder possessed a legal right to payment. This would cause the instrument to be treated as equity for tax purposes. However, a determination that an instrument is not very risky should not negate the fact that the issuer has no legal obligation to make a payment on the instrument under the instrument’s formal legal terms. In other words, the riskiness of an instrument could make promises to pay illusory with the result that a court would not respect those promises in characterizing the instrument. However, we can consider the reverse by imagining that the parties have made abundantly clear that a low-risk issuer will be excused from making payments in the event of financial difficulty. The fact that the instrument is not risky (in the sense that financial difficulty is unlikely) arguably should not convince a court that the parties intend for the holder of the instrument to have a definite right to be repaid a fixed amount at a certain time, regardless of the income of the obligor. The parties have explicitly provided otherwise.

100. See id. (conceptualizing this category as factors “bearing on the reasonableness or economic reality of [the intention to create a debtor-creditor relationship] (the risk element”).

101. See id. (describing these factors as relevant to the “risk element”).

102. See infra note 103 and accompanying text (discussing how some courts follow this approach but some do not).

103. A number of courts follow an approach similar to what is described above. See, e.g., Plumb, supra note 96, at 413. The presence of a maturity date does not guarantee recognition of indebtedness, if other factors indicate an equity investment, since “it is not unusual for preferred stock to have a maturity or retirement date” and since there may be an unexpressed intention not to enforce the obligation when it comes due. But the absence of such an unconditional right to demand payment is most often conclusive. However, some courts have departed from this approach. See, e.g., Plumb, supra note 96, at 415 (“There are some cases, however, holding that contingency of
Finally, courts employ some factors to judge whether the advance would be repaid even if funds were available and even if the holder has a technical right to enforce payment. In particular, factor (8) above assists courts with this inquiry. To take an extreme example of a situation in which factor (8) applies, imagine that one individual owns 100% of the equity of a corporation, and that individual also makes a loan to the corporation. Even if the formal terms of the instrument provide the holder with a right to enforce a definite payment obligation, courts might be skeptical of the likelihood that the holder of the instrument would enforce that right, given that the holder would be enforcing the right against his or her wholly-owned corporation. That said, courts will not, inevitably, re-characterize the instrument as equity for tax purposes. The instrument could be respected as debt, as long as, based on other factors (such as the corporation not being too thinly capitalized), the instrument was not excessively risky. In such a case, the rationale for respecting it as debt may be that if an unrelated person were to make an arms-length loan on the same terms and if the loan from the unrelated person would have been respected as debt for tax purposes, then there is no reason why the same instrument should not also be considered debt when it is held by the corporation’s sole owner.

 ultimate payment upon availability of earnings is not conclusive against the existence of a debt, at least if there is a reasonable expectancy that full payment will occur.”). The IRS also has departed from this method of analysis in a chief counsel advisory. \textit{Infra} notes 136–137 and accompanying text.

104. \textit{See} Plumb, \textit{supra} note 96, at 411–12 (conceptualizing this category as factors “bearing on the genuineness of the intention to create a debtor-creditor relationship”).

105. Other factors that courts use to address this question could include: (1) whether payments have been made on the instrument when due, (2) if payments were not made when due, whether the holder brought legal action to enforce payment, and (3) other, similar factors. Plumb, \textit{supra} note 96, at 412.

106. \textit{See}, \textit{e.g.}, Plumb, \textit{supra} note 96, at 406 (“\textit{The limitations on the rights of purported creditors that must be carefully spelled out in the instruments when outside investors are involved may exist as tacit understandings when the common shareholders or closely related parties themselves supply the funds.”}).

107. \textit{See}, \textit{e.g.}, \textit{id.} at 470 (“Once it is acknowledged, however, that a shareholder may occupy a dual status as investor and creditor, proportionality per se cannot be viewed as affirmative evidence for treatment of purported debt as equity.”).
Consider the example of an instrument that is classified as debt for tax purposes, but equity for state usury law purposes. These different regulatory regimes could reach different results because one is predominantly substance-based, while the other is more form-driven. As discussed above, tax law classifies instruments as debt or equity based on substantive factors.\textsuperscript{108} On the other hand, state usury laws in a given jurisdiction might adopt a more formal classification system, relying more heavily upon the labels adopted by the parties.\textsuperscript{109} Assume a given state has adopted a form-based system mainly for reasons of administrative convenience (because form is more readily apparent), but for other policy reasons, the state would prefer a more substance-based definition. If this is the case, then treating the instrument differently for purposes of usury law than how it is treated for tax purposes may be undesirable. Because the difficult work of classifying based on substance is already necessary for tax purposes, such a state might decide to reform its usury law definition to tie classification to the tax classification, if the state’s only rationale for using a form-based system is administrative ease.

Of course, in many cases, the “substance” that is relevant for state usury law purposes would not be the same “substance” that is relevant for tax purposes. State usury laws are generally aimed at protecting the recipient of an advance of funds from advantage-taking by the person who makes the advance. Presumably, equity is exempted from state usury laws because a high return on equity takes advantage of no one, so long as the equity is subordinate to all other interests in the venture. In other words, if a debt-holder is paid before an equity-holder, a high

\textsuperscript{108} See \textit{supra} notes 98–106 and accompanying text (discussing factors considered when determining whether an instrument is equity or debt for tax purposes).

\textsuperscript{109} It seems that this was true in the case of the usury laws applicable in \textit{Jones Syndicate}. \textit{Supra} note 78 and accompanying text. For a more modern example, consider \textit{Bollinger}. \textit{Supra} note 79 and accompanying text. For purposes of determining who the borrower was in \textit{Bollinger}, the applicable state usury laws examined who held formal legal title to the property that secured the loan rather than relying upon more substantive indicia of ownership. Comm’r v. Bollinger, 485 U.S. 340, 347–49 (1988).
interest rate on the debt detracts from the return earned by the equity-holder. A high return on equity harms no one given that the equity-holder’s claim is not preferred to the claims of others. Based on this line of thinking, if usury laws were based on substance, subordination of a claim would seem to be the pre-eminent factor in any analysis of whether a claim was debt or equity. If a claim was subordinated to all other claims, it would clearly be equity for state usury law purposes. If a claim was not subordinated to all other claims, it might not be equity for state usury law purposes.\footnote{Perhaps, even if an instrument was not subordinated to all other claims, state usury laws might classify it as equity if it was sufficiently risky to justify a higher rate of return. That could be the case. However, many of the circumstances in which a lender might charge a high rate of interest are circumstances in which the rate might be risk-based (based on the borrower’s lack of credit history or bad credit history, for instance), and yet, these are the typical circumstances in which state usury laws would apply. In any case, the analysis above is designed as merely an illustration of the process that regulators might follow when analyzing whether inconsistent treatment is or is not appropriate. In particular, regulators should consider the goals of each regime, and based on those goals, determine which substantive factors are relevant to classify a given instrument or transaction.}

Layered on top of this, one could imagine state usury laws not applying to a debt instrument if the borrower was deemed to be sophisticated (using any number of plausible proxies for sophistication), and therefore, less likely to fall victim to an unscrupulous lender.\footnote{In \textit{Commissioner v. Bollinger}, for instance, the state usury laws would not apply to a loan made to a corporation, but would have applied to a loan made to the corporation’s sole owner, perhaps based on the dubious (and form-driven) assumption that corporations are sophisticated. 485 U.S. 340, 347–49 (1988).}

In the tax context, subordination of a claim to other creditors is one factor that increases the likelihood that the claim will be classified as equity for tax purposes, given that subordination increases the risk that the holder will not receive payment.\footnote{See, \textit{e.g.}, Plumb, \textit{supra} note 96, at 421–30 (discussing the use of subordination to other creditors as a factor in the tax analysis).} Therefore, there is some overlap between the factors that are relevant to the tax analysis and the factors that could be relevant to a substance-based state usury law analysis.

However, some of the factors that weigh in favor of equity for tax purposes have no bearing on the primary concern behind state usury law—namely, the possibility that the holder of the
instrument could take advantage of the owners of business by requiring a high return. For instance, imagine a corporation acquires assets worth $1,000. The corporation, in turn, has issued three instruments to raise the capital used to acquire its assets: (1) one instrument (Clear Debt) that is clearly debt for all purposes (tax and usury law), (2) a second instrument (Ambiguous) whose classification is ambiguous, and (3) a third instrument (Clear Equity) that is clearly equity for all purposes (tax and usury law). The holders of Ambiguous have claims to income of the corporation and assets on liquidation that are subordinated to the claims of Clear Debt, but prior to the claims of Clear Equity. Because the claims of Ambiguous are prior to the claims of Clear Equity, the possibility of advantage-taking cannot be entirely ruled out, so debt would be an arguably appropriate classification for state usury law purposes.

The instrument’s tax classification would depend on a number of other factors in addition to subordination. For instance, with a thinly capitalized corporation (meaning the ratio of its debt to its equity is high), the riskiness of Ambiguous increases substantially, and therefore, so too do the odds of Ambiguous being treated as equity for tax purposes. Compare, for instance, Example 1 (Clear Debt is $700, Ambiguous is $100, and Clear Equity is $200) to Example 2 (Clear Debt is $200, Ambiguous is $100, and Clear Equity is $700). Ambiguous is a much riskier instrument in Example 1 than in Example 2. In Example 1, if the value of the corporation’s assets were to decrease by more than $200 (which represents 20% of the total asset value), Ambiguous would not be repaid in full. In Example 2, however, the value of the corporation’s assets could decrease by $700 (which represents 70% of the total asset value) before Ambiguous received less than full repayment. Because Ambiguous is much riskier in Example 1, it is much more likely that Ambiguous would be classified as equity for tax purposes in Example 1. At the same time, increasing the proportion of assets funded by Clear Debt does not necessarily lessen the concern that the holders of Ambiguous could take advantage of the holders of Clear Equity by exacting a high rate of return. As long as someone is in line behind Ambiguous, potential

113. See, e.g., id. at 507–19 (discussing the use of thin capitalization as a factor in the tax analysis).
for advantage-taking exists. Accordingly, thin capitalization does not necessarily suggest that an instrument should be treated like equity for state usury law purposes. The increased risk should, arguably, increase the maximum allowable interest rate, but it would not necessarily lead to the conclusion that usury laws ought not apply at all.

As mentioned above, some of the factors used in the tax analysis of debt versus equity do not relate the risk of the instrument (whether the instrument can be repaid), but instead inform the question of whether the advance will be repaid.\footnote{See supra notes 104–107 and accompanying text (describing factors relevant to the evaluation of whether an advance will be repaid).} For instance, if an instrument that is purportedly “debt” is held by the owners of the equity of a business and held in the same proportion as the proportion in which they hold the equity, the chances that the instrument will be reclassified as equity for tax purposes increase.\footnote{See supra notes 104–107 and accompanying text (discussing how the chances that an instrument will be reclassified as equity for tax purposes increase if the instrument is held by the equity-holders in the same proportion as the proportion in which they hold the equity).} To illustrate, assume that, in Example 1 and Example 2 above, two entities each own 50% of the Clear Equity. The likelihood of Ambiguous being classified as equity in either example increases if those same two entities also own 50% of Ambiguous. If they each own 50% of each instrument, then the entities will be indifferent between the corporation making a given payment to the holders of Ambiguous or to the holders of Clear Equity, because, in either case, they each receive 50% of the payment. Consequently, if the corporation were to encounter some temporary financial trouble such that forgiving payments due on Ambiguous might increase the corporation’s overall value, the holders of Ambiguous would be very unlikely to enforce payment obligations. Each holder is compensated for any amount that either loses equally on Ambiguous by an equally increased return on Clear Equity.

This same factor (the instrument being held in the same proportion as equity) should also obviate the need to worry about advantage-taking by the holders of Ambiguous. A high rate of return on Ambiguous detracts only from the return on Clear Equity. If both instruments were held by the same entities and
were held in the same proportion, then any harm done to either entity as a result of holding Clear Equity would inure to the benefit of that same entity as a result of holding Ambiguous. Therefore, proportionate ownership would also be a factor that would weigh in favor of treating Ambiguous as equity for state usury law purposes if state usury laws were to employ a substance-based analysis.

Even though proportionate ownership is a factor that weighs in favor of classifying an instrument as equity for tax purposes, it does not, under current doctrine, end the tax analysis. Owners of something that is clearly equity could still make loans to a corporation that could be respected as debt for tax purposes, even if the loans were made in proportion to their equity ownership. To take an extreme example, imagine that one entity owned 100% of the stock of a corporation. That entity could make a loan to the corporation that was respected as debt so long as the instrument was not excessively risky (based on other factors, such as the corporation not being too thinly capitalized). In such a case, however, the reasoning described above would still suggest that the instrument should be equity for purposes of state usury laws. An entity would not take advantage of its wholly-owned corporation by making a loan and charging an excessively high rate.

Given that different “substance” matters to each regime, inconsistent treatment, in some cases, is appropriate. For example, assume an instrument is classified as equity for tax purposes, but debt for state usury law purposes. This inconsistency may be appropriate if the claims of some equity-holders are subordinated to the claims of the instrument-holder (so that it is classified as debt for state usury law purposes given the potential harm that could befall the holders of the subordinated claims), but the obligor on the instrument was thinly capitalized (so that it is classified as equity for tax purposes given the riskiness of the instrument). As another example, assume an instrument is classified as debt for

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116. See supra notes 104–107 and accompanying text (noting that it is possible for an instrument to be classified as debt even when it is held by the equity-holders in the same proportion as the proportion in which they hold equity).

117. Supra notes 104–107 and accompanying text.

118. Supra notes 104–107 and accompanying text.
tax purposes, but equity for state usury law purposes. This inconsistency may be appropriate if the instrument is held in the same proportion as any claims that are subordinated to it (so that it is classified as equity for state usury law purposes given that there is no potential for a high rate of return on the instrument to harm the holders of subordinated claims) and, at the same time, various facts support classifying the instrument as debt for tax purposes (for instance, the terms of the instrument provide the holder with a definite and legally enforceable right to payment on a date that is not far in the future, and the entity is not thinly capitalized).

In other cases, inconsistent treatment may be inappropriate. For example, if an instrument was treated as debt for tax purposes because its holders had claims to income of the entity and assets upon liquidation that were prior to the claims held by all others and the venture was not thinly capitalized, the instrument should likely be classified as debt for state usury law purposes as well (assuming no countervailing factor, such as the fact that the instrument is held in the same proportion as the subordinated claims). In such a case, inconsistent treatment would likely occur only if the applicable state usury law regime employed a classification scheme based on form rather than substance, which might not be justified by considerations of administrative ease if the work of substance-based determinations must already be undertaken for tax purposes.

C. Tax and Capital Requirements

Just as a taxpayer might design an instrument that is debt for tax purposes, but equity for purposes of state usury law, so too might a bank issue an instrument that was debt for tax purposes, but equity for purposes of capital requirements. Bank capital requirements are generally aimed at reducing the risk that a bank will become insolvent. In addition to other requirements, a bank

119. See, e.g., Julie Andersen Hill, Bank Regulation by Enforcement: An Empirical Study, 87 Ind. L.J. 645, 649 (2012) (“Other things being equal, banks that hold more capital are less likely to become insolvent and inflict losses on depositors.”).
will be required to maintain a minimum “leverage ratio.” The “leverage ratio” is the ratio of the bank’s “tier one capital” to total assets. “Tier one capital” includes instruments issued by the bank that are categorized, for bank regulatory purposes, as various types of equity.

A higher “leverage ratio” reduces the risk of insolvency. If a bank’s assets fall in value, but still exceed the value of deposits and other liabilities, the bank remains solvent. Thus, a higher leverage ratio decreases the risk of insolvency because “tier one capital” bears the first losses.

For instance, assume a bank’s total assets were worth $100 million. Assume the bank acquired those assets using $70 million held in deposit accounts at the bank and $30 million raised by issuing equity (“tier one capital”). If the assets declined in value, but not below $70 million, the bank would remain solvent and able to honor the claims of deposit-holders. The first $30 million in losses would be borne by the equity-holders. The risk that this bank would become insolvent is lower than the risk of insolvency for an otherwise identical bank with a lower ratio of equity to assets. For instance, if the otherwise identical bank were to acquire $100 million in assets using $90 million held in deposit accounts and $10 million raised by issuing equity, its risk of insolvency would be much greater.

A bank might issue a preferred stock instrument with enough debt-like features so that it constitutes debt for tax purposes, but

120. See id. at 650–51 (discussing the leverage ratio requirement and other requirements).
121. See id. at 651 (defining “leverage ratio”).
122. See id. (defining “tier one capital” as “essentially common stock, noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries”).
123. See id. (providing an example of how a higher “leverage ratio” lowers the risk of insolvency).
124. See id. at 649 (stating that holding more capital reduces the chance of a bank becoming insolvent).
125. See id. at 651 (describing banks with a higher “leverage ratios” as generally subject to a lower risk of insolvency).
126. See id. at 649 (“[B]anks that hold more capital are less likely to become insolvent and inflict losses on depositors.”).
127. See supra note 123–125 and accompanying text (discussing the decreased risk that comes from a higher “leverage ratio”).
equity for purposes of capital requirements. This combination would provide the bank (or, more precisely, its common stockholders) with the best of both worlds. Because the instrument was classified as debt for tax purposes, the bank would be entitled to an interest deduction that could increase the after-tax return earned by the common stockholders.\textsuperscript{128} Because the instrument was classified as equity for purposes of capital requirements, the bank could issue the instrument in lieu of additional common stock, which would have diluted the ownership interest held by the common stockholders.\textsuperscript{129}

As mentioned, the aim of bank capital requirements is to reduce the risk of insolvency.\textsuperscript{130} Therefore, a substance-based classification scheme would categorize an instrument as equity for bank regulatory purposes only if the holder cannot legally enforce payment on the instrument—or, more precisely, only if the holder’s rights of enforcement are limited to the claim that the instrument precedes the common stock. In other words, an instrument could be equity if its holders have the right to require that they are paid before the holders of the common stock, so long as they do not have the right to enforce payment when no payments are made with respect to the common stock. Furthermore, an instrument that had a maturity date (or a date on which redemption was required) would be problematic because the bank’s failure to make the required payment could result in insolvency. Likely for these reasons, perpetual preferred stock is classified as “tier one capital.”\textsuperscript{131} Regulators might accept an instrument with a maturity date, but only if payment would be excused in circumstances in which there was a greater than negligible risk of insolvency.

Based on this logic, it is difficult to see how anything that is properly classified as equity for purposes of bank regulatory

\textsuperscript{128} \textit{See supra} note 26 and accompanying text (addressing a bank’s ability to deduct interest expense on debt for tax purposes).

\textsuperscript{129} \textit{See, e.g.}, Hill, supra note 119, at 649 (“O}nce a bank has raised capital by issuing stock, the stockholders expect a return on their investment. Banks can increase the expected return on equity by holding more liabilities relative to their capital[—]that is, by increasing their leverage.”).

\textsuperscript{130} \textit{See supra} note 119 and accompanying text (discussing the main aim of bank capital requirements).

\textsuperscript{131} \textit{See, e.g.}, Hill, supra note 119, at 651 (describing what constitutes “tier one capital”).
requirements could constitute debt for purposes of tax law. In tax law, a number of courts echo some variation of the refrain that an instrument is debt only if the parties intend for the holder of the instrument to have a definite right to be repaid a fixed amount at a certain time, regardless of the income of the obligor. As just discussed, something should only be equity for purposes of capital requirements if its holder has no definite right to payment. Thus, the determination that something is equity for purposes of capital requirements would seem to be in direct conflict with the conclusion that it is debt for tax purposes.

As a practical matter, an instrument properly classified as equity for purposes of capital requirements might be classified as debt for tax purposes because courts (or the IRS) lose sight of the forest for the trees. The ultimate determination in tax law, according to a number of courts, turns on whether or not the parties intend for the holder of an instrument to have a definite right to payment. To determine whether the parties possess the requisite intent, courts engage in an examination of a long list of objective factors. These factors can include, among others, whether the issuer is thinly capitalized, the liquidity of the issuer’s assets, the stability of the issuer’s revenues, the terms of the instrument (such as the length of the term to maturity), and subordination of the instrument to other creditors. In some cases, courts might allow the examination of factors to supplant the ultimate determination, or the IRS might do the same when it issues administrative guidance regarding the tax classification of certain instruments. Thus, for instance, assume a bank issues

132. See supra note 96 and accompanying text (describing use of this definition of “debt” for tax purposes).
133. Supra note 96 and accompanying text.
134. See supra note 98 and accompanying text (listing eight factors as among those that can be considered).
135. See supra note 98 and accompanying text (discussing factors considered by courts).
136. In many cases, the IRS will be the source of guidance. For example, in a 2009 Chief Counsel Advisory, the IRS determined that it should not challenge the taxpayer’s characterization of trust preferred securities as debt for tax purposes. See, e.g., I.R.S. Chief Couns. Adv. Mem. 200932049, at 15 (Aug. 7, 2009) [hereinafter I.R.S. CCA Mem.]. As mentioned above, at the time, trust preferred securities were treated as “tier one capital” for certain banks. See supra note 39 and accompanying text. In this CCA, the IRS did not treat the holder’s definite right to payment as the ultimate question. See I.R.S. CCA Mem., supra note 136,
an instrument that decidedly does not grant the holder a definite legal right to payment (so that it can be classified as equity for purposes of capital requirements). Further, assume the bank is not thinly capitalized, earns a stable stream of revenue, and holds significant liquid assets. Because these three factors are generally factors that weigh in favor of classifying an instrument as debt for tax purposes, a court might classify this instrument as debt, notwithstanding the fact that the lack of legal right to enforce payment would seem to undercut the conclusion that the parties intend for the holder to have a definite right to payment. Likewise, if an instrument is properly characterized as debt for tax purposes, bank regulators might, nevertheless, classify it as equity if they decide to exercise more leniency and accept some risk that the holders of the instrument could enforce payment, leading to insolvency.

To demonstrate, imagine that a bank issues a preferred stock instrument and that the bank is required to redeem the instrument at some point in time, but not for a number of years. Furthermore, assume that the obligation to redeem the instrument would be excused in circumstances in which the bank faced financial difficulty. Based on an examination of various facts (such as the bank’s operating history and the fact that the bank is not thinly capitalized), facing the type of financial difficulty that would excuse payment is unlikely. Under this mix of facts, bank regulators might determine that the instrument is equity because the holder’s “right” to repayment does not kick in until the distant future and is sufficiently watered down by conditions under which the payment is excused. At the same time, based on other facts, the likelihood that payment will in fact occur is high, despite the fact that the holder does not have a definite legal right to payment. Under these facts, the IRS or the courts might determine that the instrument is debt for tax purposes if they focus on the likelihood that payment will occur, rather than focusing on the holder’s right to payment.137 Arguably, this method of analysis is mistaken. As

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137. The Chief Counsel Advisory in which the IRS decided to not challenge a taxpayer’s characterization of trust preferred securities as debt for tax purposes.
described above, the riskiness of an instrument could make a definite obligation to pay illusory and without substance (so that a risky instrument should be treated as equity even if the holder has a formal legal right to payment). On the other hand, if the terms of an instrument explicitly provide that the holder lacks a fully enforceable right to payment, then the fact that payment is likely should not affect a court’s analysis of whether the parties intend for the holder to have a definite right to payment.

Thus, the inconsistency of instruments that are classified as equity for purposes of bank capital requirements, but as debt for tax purposes, ought to raise suspicion. In some cases, it might be a signal to the IRS and to courts to reconsider the instrument’s

provides a useful illustration. See I.R.S. CCA Mem., supra note 136, at 16. In the CCA, the IRS stated:

The fact that the holders of the Preferred Securities have creditor rights of practical significance is probative of debt. However, the Preferred Securities are subject to several conditions which, if implemented, would cause the periodic payments to be more analogous to traditional preferred stock dividends than to traditional interest on long term debt. These include the right of the Taxpayer voluntarily to defer payments for prolonged periods, limitations on the sources from which deferred payments can be satisfied, and the potential loss of a portion of deferred payments in the event of bankruptcy.

In other words, the “rights” of the holders to enforce payment are fairly weak, especially in case of financial difficulty, as they likely must be for the instrument to be treated as equity for bank regulatory purposes. In the CCA, the IRS continues by stating:

The likelihood of these conditions being implemented, however, appears to be remote. Taxpayer has an extensive, consistent history of dividend payments on its common stock which it will have a substantial economic incentive to maintain and which would be prohibited if payments were deferred on the Preferred Securities. Taxpayer indicated that it did not intend to defer payments, and has sufficient capitalization, liquidity and long term business prospects to justify the assumption that it will be able to comply with that intention.

Thus, the IRS switched gears from considering the rights of the holders to receive payment to analyzing the likelihood that payment will occur. Based on the high likelihood that payment will occur, the IRS determined that it should not challenge the characterization of the instruments as debt for tax purposes. Id.

138. See supra Part IV.A (“[I]f the relevant factors suggest that an instrument is very risky, that determination could undercut a determination that the holder possessed a formal legal right to payment, so that the instrument would be treated as equity for tax purposes.”).
classification for tax purposes. In other cases, it might be an indication that the instrument is not, in fact, serving the goals of bank regulators.

D. Summary

Although inconsistent treatment across regulatory regimes is not always problematic, it sometimes occurs because one or more of the regulatory regimes suffers from some shortcoming. Even in such a case, the inconsistency is not the problem—rather, one or more of the regulators has improperly applied the relevant law or has applied law that does not properly serve the purposes of a given regime. Thus, one of the useful implications of the

139. One might object to tying tax classification more closely to bank regulatory classification on efficiency grounds. In particular, one might argue that it will induce banks to issue more instruments that give the holders a definite right to payment so that the instrument would be debt for purposes of both regimes. This shift could have the detrimental effect of increasing the risk of insolvency. In response, two observations could be made. First, this shift could only occur in the case of banks that currently have issued more equity than the minimum required by bank regulators. Second, if the shift would increase insolvency risk beyond an acceptable level, then the solution is in the hands of bank regulators—they ought to increase the amount of required capital. See supra notes 119–125 and accompanying text (discussing how increased capital reduces the risk of insolvency). Of course, if they would not do so because of political pressure from regulated parties, then tying the regimes more closely together could have adverse effects. See Schizer, supra note 39, at 1338.

[I]t is undesirable for the tax law to create political pressure to repeal a helpful friction. For instance, assume that a regulated financial institution cannot claim a tax deduction without triggering adverse regulatory treatment, as when accounting losses require regulators to take over the institution. If this tough regulatory treatment ensures the solvency of regulated institutions, it would be undesirable for regulators to weaken their standards solely to make the tax deduction easier to claim.

140. Indeed, the classification of trust preferred securities as “tier one capital” for certain banks was phased out by the Dodd–Frank Wall Street Reform and Consumer Protection Act. See Baltali & Tanega, supra note 39, at 43 (“Given Dodd-Frank Act’s § 171, neither trust preferred securities nor cumulative perpetual preferred stock would qualify for inclusion as tier 1 capital among the top 50 [bank holding companies].”).

141. See Barry, supra note 8, at 75 (discussing how inconsistent treatment is not always a problem, but may be caused by inappropriate treatment by one regime).

142. See id.
conclusion reached by this Article is that, at the end of day, coordination across regulatory regimes may be unnecessary. If each regulator appropriately applies properly designed law, then any resulting inconsistency is acceptable. However, in some cases, inconsistency could serve as a useful flag, alerting a regulator to an inappropriate classification under a given regime. 143 In such cases, coordination among regulators would be required for regulators to learn about inconsistent treatment and the relevant classification rules of other regulatory regimes, but many obstacles could prevent effective coordination. 144 To facilitate awareness of inconsistent treatment, lawmakers could require regulated parties to file notices with relevant regulators highlighting inconsistent treatment. 145 For instance, lawmakers could require that any taxpayer subject to capitalization requirements must file a disclosure with the IRS if any financial instrument that it issues is classified differently for capitalization requirements purposes than for tax purposes. Alternatively, regulators could share more general information directly with other regulators. For instance, bank regulators could provide the IRS aggregate data regarding the characteristics of instruments that are treated as “tier one capital” so that the IRS could consider whether those characteristics could be consistent with the tax classification of debt.

To the extent that there is a problem, it is that one or more of these regimes treats the securities inappropriately. If the securities really represent an equity interest within the policy goals of the tax law, then the tax law is inappropriately treating the securities as debt; if the securities really represent debt within the policy goals of the banking regulations, then the banking regulations are incorrectly treating them as equity.

143. See id. ("The difference in treatment between regimes is an indicator that one of the regulatory regimes may be treating them inappropriately, but the difference in treatment is not a problem in and of itself.").

144. See, e.g., Schizer, supra note 39, at 1335–36 (discussing of some of the obstacles to effective coordination).

145. Taxpayers are required to disclose to the IRS inconsistency between tax and accounting treatment in some cases. See News Release, I.R.S., Treasury and IRS Issue Revised Tax Form for Corporate Tax Returns (July, 7, 2004).
V. Inconsistency Nullifies a Friction

By claiming inconsistent treatment, a sophisticated party can obtain a favorable tax outcome without sacrificing his or her non-tax regulatory goals. Thus, the ability to claim inconsistent treatment nullifies what could otherwise be a potent friction against tax planning. In particular, if the taxpayer could not claim inconsistent treatment, the taxpayer might abandon certain tax planning if it would result in significantly less advantageous non-tax regulatory treatment. Given the ability to claim inconsistent treatment, the planning can proceed undeterred.

In some cases, moreover, a taxpayer’s efforts to obtain favorable non-tax regulatory treatment actually facilitate, rather than impede, tax planning. For instance, as discussed above, a taxpayer who selected a transactional form in order to obtain non-tax regulatory benefits will be more likely to succeed in disavowing that form in order to obtain a more favorable tax outcome than a taxpayer whose form did not produce non-tax benefits.146

A. Frictions Against Tax Planning

Others have noted that taxpayers’ aims to achieve favorable results under non-tax regulatory regimes can sometimes serve as “frictions” against tax planning.147 “Frictions” against tax planning

146. See supra Part II.C (discussing circumstances in which obtaining benefits under a non-tax regulatory regime can increase the odds of a taxpayer successfully disavowing his or her selected form to obtain a more favorable tax outcome). Another example would be the way in which attaining a favorable non-tax regulatory outcome can serve the role of demonstrating “business purpose” under the economic substance doctrine. See Lederman, Economic Substance, supra note 52, at 433 (“[N]on-tax regulatory requirements seem to provide a business purpose . . . .”).


As is well known to any tax adviser, corporate goals in one regime often run counter to the goals under another. Specifically, for financial accounting purposes corporations would typically prefer to report higher income, whereas for tax purposes corporations would typically prefer to report lower income. This can create an important “friction” with respect to tax planning. That is, to the extent that aggressive tax planning reduces income for tax and corporate purposes, the firm may
are non-tax costs that a taxpayer must bear in order to obtain a more favorable tax outcome. Because of such frictions, taxpayers will sometimes abandon attempts to structure their transactions to avoid adverse tax treatment if such structuring would result in undesirable accounting treatment, adverse non-tax regulatory treatment, or a sub-optimal business outcome.

Frictions can be a useful supplement to the tax law. Without frictions, a taxpayer might alter his or her behavior or transactions just enough to avoid an adverse tax outcome under a given statute or regulation so that the statute or regulation fails to collect the intended tax revenue and serves only to encourage taxpayers to engage in planning. Given the presence of frictions, taxpayers opt not to engage in the tax planning in the first place.

148. See, e.g., Myron S. Scholes & Mark A. Wolfson, Taxes and Business Strategy: A Planning Approach 7 (1992) (“By frictions we mean transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly.”). Frictions could discourage not just tax planning, but also tax avoidance. See, e.g., Leandra Lederman, Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance, 60 STAN. L. REV. 695, 699 (2007) [T]he tax law often fails to extend the favorable tax treatment afforded particular reimbursed expenses or losses to similar but unreimbursed items. This distinction... reflects the enforcement benefits that a reimbursement provides—including the presence of a third party who implicitly has “vouched” for the bona fides of the taxpayer’s claim... Although third parties can thus provide a type of “friction” that reduces tax avoidance, they do not do so in all contexts.

149. See, e.g., Schizer, supra note 39, at 1323 (“Even if a narrow rule does not cover a particular avoidance strategy, taxpayers will not use this “out” if key business and legal objectives cannot be satisfied.”); Deborah H. Schenk, An Efficiency Approach to Reforming a Realization-Based Tax, 57 TAX L. REV. 503, 508–13 (2004) (discussing the effects of friction on tax planning).

150. See, e.g., Schizer, supra note 39, at 1323 (“Even if a narrow rule does not cover a particular avoidance strategy, taxpayers will not use this ‘out’ if key business and legal objectives cannot be satisfied.”).

151. See, e.g., id. at 1320 (“Halfhearted efforts [to prevent tax planning] may merely add to the cost of planning without deterring anyone, thereby increasing social waste without collecting more revenue.”).
will not, in some cases at least, undertake the tax planning required to avoid an adverse tax outcome because the planning would impose non-tax costs that exceed the tax benefits. The non-tax costs result from frictions, which could take the form of less favorable non-tax regulatory outcomes, less favorable accounting treatment, or sub-optimal business outcomes, for instance.

The ability of sophisticated parties to simultaneously obtain favorable treatment under multiple regulatory regimes can nullify the effects of otherwise potent frictions against tax planning. Dean Schizer uses the term “malleable” to describe a friction that can be avoided by characterizing a transaction for tax purposes in a manner that differs from its accounting or other non-tax treatment.

Thus, one objection to the ability to obtain inconsistent treatment is that, by facilitating tax planning, inconsistent treatment exacerbates many of the negative ramifications of tax planning. As mentioned above, tax planning is problematic for three reasons, at least when it is not the type of planning that tax law is designed to encourage. First, it reduces tax revenue. Second, it perpetuates unfairness as well as the perception that

152. See, e.g., id. at 1323–26 (describing, in general terms, when frictions will prevent tax planning).

153. See id. at 1326–34 (discussing potential frictions including the effects of planning on business outcome, non-tax regulatory treatment, and accounting treatment).

154. See supra note 51 and accompanying text (discussing how inconsistent treatment can make it so that non-tax regulatory regimes no longer act as an effective friction against tax planning).

155. See Schizer, supra note 39, at 1324 (“Can the deal be tweaked so the expense no longer depresses accounting earnings, but still generates a tax deduction? If so, the accounting friction is malleable and will not stop the tax planning.”).

156. See id. (pointing out that malleable frictions do not stop tax planning).

157. See supra notes 89–93 and accompanying text (mentioning the potential negative consequences of tax planning).

158. See id. (stating that tax revenue is lost when parties seek out beneficial tax outcomes).
the tax system is unfair.\textsuperscript{159} Third, it potentially undermines efficiency.\textsuperscript{160}

However, as others have noted, limitations on tax planning do not necessarily further efficiency.\textsuperscript{161} Sometimes limitations on tax planning further efficiency by prompting taxpayers to select transactions for non-tax reasons alone.\textsuperscript{162} However, sometimes limitations that foreclose certain tax planning strategies simply

\textsuperscript{159}. See supra notes 89–93 and accompanying text (mentioning the effects of tax planning on fairness and perceptions of fairness).

\textsuperscript{160}. See supra notes 89–93 and accompanying text (discussing the potential effects of tax planning on efficiency).


Ultimately, the effect of any reform on the planning option turns on empirical questions. Some taxpayers will be stopped from planning . . . This is a good result because extra revenue is collected without distorting taxpayer behavior. On the other hand, some taxpayers will change their transactions to avoid the reform . . . In these cases, revenue does not increase[,] . . . while the tax rules do distort taxpayer behavior. The relative magnitude of these effects determines the reform’s overall impact on planning-related waste.

Weisbach, \textit{Line Drawing}, supra note 93, at 1669–70

[W]e cannot simply interpret the models as suggesting that lines in the tax law should be made harder to avoid. A line can be too hard to avoid, at least from an efficiency perspective. This can happen because there are two components in the deadweight loss triangles (or marginal deadweight loss trapezoids): the width (reflecting elasticity) and the height (reflecting the size of the tax). Taxing a low-elasticity item too high is not optimal. We can think of these dimensions as the number of taxpayers that shift their behavior (the width) and the social cost (loss of consumer surplus) for each shift (the height). If a line is too hard to avoid, there may be few shifts, but each shift will have a large cost. Making the line easier to avoid effectively reduces the tax on an activity because it is cheaper to avoid the tax. This may reduce deadweight loss even though additional taxpayers will alter their behavior.

See generally Philip A. Curry et al., \textit{Creating Failures in the Market for Tax Planning}, 26 VA. TAX REV. 943 (2007) (discussing how policymakers face a trade-off when considering measures to attack current tax planning strategies, namely, the trade-off between (i) costs arising from taxpayers’ use of those current tax planning strategies and (ii) costs arising from taxpayers’ search for new tax planning strategies once the existing methods are attacked).

\textsuperscript{162}. See supra note 161 and accompanying text (discussing the efficiency effects of tax planning limitations).
cause taxpayers to shift to other, potentially even more wasteful tax planning strategies.163

To demonstrate, assume that by engaging in one transaction (Transaction A), a taxpayer would earn, over one year, a 14% pre-tax return, but a 12% after-tax return. By contrast, by engaging in a different transaction (Transaction B) over the same time period, the taxpayer would earn a 15% pre-tax return, but a 10% after-tax return. If the taxpayer engages in tax planning, he or she will consider tax consequences when evaluating the transactions and will likely opt for Transaction A because it maximizes the taxpayer’s private wealth. From a societal standpoint, however, the choice to engage in Transaction A is wasteful. Investing $100 in Transaction A for one year yields a total of $114 instead of the $115 total from Transaction B. If the taxpayer engaged in Transaction A, he or she will pay only $2 in tax for a net profit of $12. When the taxpayer engages in Transaction B, he or she will pay $5 in tax for a net profit of $10. Therefore, although Transaction A generates more individual wealth, the total profit from Transaction A is $1 less than the total profit from Transaction B. These results are summarized in Table 1 below.

**Table 1. Numerical Example of Effects of Tax Planning**

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<tbody>
<tr>
<td>Pre-Tax Return</td>
<td>14%</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
<td>14.29%</td>
</tr>
<tr>
<td>After-Tax Return</td>
<td>12%</td>
</tr>
</tbody>
</table>

**$100 INVESTED FOR ONE YEAR:**

| Total Profit | $14 | $15 |

163. Supra note 161 and accompanying text.
Tax Paid

$2  $5

Profit Retained by
Taxpayer

$12  $10

If certain limitations on tax planning make it so that the after-tax return earned by the taxpayer from Transaction A is lower than the after-tax return earned from Transaction B, then, in some cases, the taxpayer will opt for Transaction B. In those cases, limitations on tax planning will further the goal of efficiency. In other cases, limiting certain tax planning strategies could encourage taxpayers to refocus their efforts on even more wasteful strategies. For example, limitations that lower the after-tax return of Transaction A, in the above example, will not improve overall efficiency if other available, comparable transactions continue to yield lower pre-tax returns, but higher after-tax returns than Transactions A and B.164

164. To demonstrate this, Table 2 shows Table 1 modified to include a third possible transaction, Transaction C. If the results of three transactions were as shown in Table 2, the taxpayer would select Transaction A because it would generate the highest after-tax return. From a societal standpoint, this choice would not be optimal because Transaction A would generate a lower pre-tax return than Transaction B, but Transaction A would be preferable to Transaction C from a societal standpoint.

**TABLE 2.**

<table>
<thead>
<tr>
<th>Transaction A</th>
<th>Transaction B</th>
<th>Transaction C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Tax Return</td>
<td>14%</td>
<td>15%</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
<td>14.29%</td>
<td>33.33%</td>
</tr>
<tr>
<td>After-Tax Return</td>
<td>12%</td>
<td>10%</td>
</tr>
</tbody>
</table>

$100 Invested for One Year:

<table>
<thead>
<tr>
<th>Total Profit</th>
<th>$14</th>
<th>$15</th>
<th>$13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Paid</td>
<td>$2</td>
<td>$5</td>
<td>$2.60</td>
</tr>
</tbody>
</table>
What is generally true of limitations on tax planning—that they sometimes further efficiency, but sometimes subvert it—is also true of frictions against tax planning. For instance, a

| Profit Retained by Taxpayer | $12 | $10 | $10.40 |

Thus, if limitations on tax planning were to reduce the after-tax return of Transaction A so that it would be lower than the after-tax return earned from Transaction B, but if those limitations did not affect the after-tax return earned from Transaction C, then taxpayers could opt for Transaction C, which would be even more wasteful from a societal standpoint.

165. See Fleischer, supra note 1, at 276 (“The same frictions touted as beneficial in deterring wasteful planning manifest as increased transaction costs when the planning takes place nonetheless.”); Kane & Rock, supra note 147, at 1254

Whether this type of friction results in social value or social cost in the aggregate is ambiguous. Frictions can create value where they operate to bolster narrow tax provisions in curtailing wasteful tax avoidance behavior. But frictions can also create social costs. With respect to some taxpayers, for example, frictions may simply raise the cost of socially wasteful behavior rather than deterring it.

Schizer, supra note 39 at 1338

Problems can arise not only if the friction has adverse nontax effects, but also if it serves a useful nontax function. It would be undesirable for the tax law to undermine a useful friction. For instance, assume the relevant friction is the taxpayer’s desire for public trading. Various governmental efforts support public trading, such as the SEC’s registration of public securities and monitoring of trading practices. These public investments are often defended because of positive externalities, or the benefits that liquid markets provide to third parties. For instance, more accurate pricing of assets provides valuable guidance even for people who are not currently trading. What if the tax burden on publicly traded securities is raised? Ideally, the nontax benefits of trading would always outweigh the tax savings, so no one would stop trading in these markets. But, in contrast, if the tax savings outweigh these nontax benefits, causing taxpayers to stop trading, taxpayers and third parties would no longer enjoy the benefits of these transactions.


Evidently, then, the rationale for an economic substance approach is
stronger linkage of tax classification to corporate law classification might prevent wasteful tax planning by some taxpayers. In particular, some would be unwilling to sacrifice a business form that was optimal for corporate law purposes in order to obtain a more favorable tax outcome. However, some taxpayers would sacrifice the optimal corporate law outcome in order to obtain a more favorable tax outcome, undermining efficiency in those cases. For this reason, the desire to maintain a friction against tax planning might not justify requiring consistent treatment across regulatory regimes.

B. Other Regulatory Regimes and Purpose

As discussed above, others have argued that the goal of efficiency might be undermined by requiring consistent treatment across regulatory regimes because the resulting friction will not stop all tax planning, and may raise the costs of the tax planning that continues. Aside from its potential to undermine efficiency,

that it may generate frictional impediments to certain socially undesirable tax planning . . . . It should be clear, therefore, that the desirability of an economic substance approach depends on two main things. The first is the social desirability of deterring optimal tax planning in the cases that are being addressed. The second is the extent to which it succeeds in generating such deterrence rather than simply inducing taxpayers to jump through a few extra hoops before getting the desired tax consequences anyway.

166. See, e.g., Fleischer, supra note 1, at 278–79
Decoupling tax and corporate law again holds promise. In the case of unincorporated entities, the tax regulations have already partially decoupled tax from corporate law. Prior to 1996, the tax classification of an unincorporated entity turned on a multifactor test that included such corporate law attributes as limited liability, centralized management, unlimited life, and free transferability of interest. Under the check-the-box regulations, most unincorporated entities may now elect whether to be treated as a partnership or a corporation for tax purposes. We still have a corporate tax; its boundaries are now effectively enforced by the publicly traded partnership rules rather than corporate law attributes. By making the tax classification of unincorporated entities elective, tax no longer distorts an entrepreneur’s decision whether to organize as a limited partnership, an LLC, or whatever new entity comes next.

167. See supra notes 165–166 and accompanying text (describing how some frictions will not stop all tax planning but will merely increase its costs).
use of another regulatory regime as the source of friction might not be ideal because it could lead to arbitrary outcomes when the other regulatory regime classifies transactions in a manner that is unrelated to the goals of tax law. In order to illustrate, consider the example of state usury laws. If we wanted to transform state usury laws into a friction that was not “malleable”—to use Dean Schizer’s term—168—we would modify tax doctrine to provide that an instrument cannot be classified as debt for tax purposes unless it would be classified as debt for tax purposes under existing doctrine and also is classified as debt for state usury law purposes. State usury laws, however, might classify an instrument as debt or equity based on form (i.e., the labels assigned by the parties) or based on substantive factors that might have little to do with the goals of tax law.169

To illustrate, assume that a state classifies instruments as debt or equity for usury law purposes based on the label assigned by the parties. Consider a taxpayer who contemplates issuing an instrument that would be treated as debt for tax purposes in order to obtain an interest deduction. But for the tax benefit obtained from the interest deduction, the taxpayer would not issue this instrument. Further, assume that if the taxpayer were only considering existing tax law (i.e., prior to the adoption of the usury law friction) and business factors, the taxpayer would issue an instrument that would yield $X\%$. Assume, if the instrument were debt for state usury law purposes, $X\%$ would exceed the maximum allowable rate. Now, assume the state usury law “friction” were adopted so that an instrument cannot be classified as debt for tax purposes unless it would be classified as debt for tax purposes under existing doctrine and also were classified as debt for state usury law purposes.

Given this change to tax law, the taxpayer could choose among three options:

Option 1. The taxpayer could refrain from issuing the instrument entirely.

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168. See supra note 155 and accompanying text (citing Dean Schizer’s use of the term “malleable” to describe frictions easily avoided by obtaining inconsistent treatment across regimes).

169. See supra Part IV.B (addressing debt and equity determinations in state usury law).
Option 2. The taxpayer could label the instrument “debt” so that it was debt for state usury law purposes and tax purposes. The taxpayer must, then, reduce the yield on the instrument to comply with state usury law. Furthermore, to make the reduced yield palatable to the holder of the instrument, the taxpayer must modify the terms in other ways, perhaps by providing security for the loan, for instance.

Option 3. The taxpayer could label the instrument “equity” and retain the yield that the taxpayer originally contemplated as well as the other terms of the instrument. Under this option, however, the instrument would be treated as equity for state usury law purposes and, therefore, also treated as equity for tax purposes. Thus, the taxpayer would not be entitled to an interest deduction.

In this example, the taxpayer would not select Option 3 because the facts of this hypothetical assumed that the taxpayer’s only reason for issuing the instrument was to obtain an interest deduction for tax purposes. If the taxpayer were to select Option 1, then the state usury laws would have fulfilled their “friction” role—they would have prevented a taxpayer from engaging in a tax-motivated transaction. If the taxpayer were to select Option 2, then the taxpayer would have persisted in engaging in a tax-motivated transaction. The result might be more or less efficient than what the taxpayer had originally planned to do, depending on whether the modifications to the terms of the instrument bring the result nearer to or farther from an efficient outcome.

The observations made so far demonstrate the argument that others have made regarding the possibility that frictions could, in some cases, further efficiency, but in others, undermine it. Aside from considering efficiency, I would argue it is worthwhile to assess whether we have served the purposes of tax doctrine. If the instrument that the taxpayer originally planned to issue would have been substantively debt without the modifications that the taxpayer must now make to it, then requiring that this taxpayer make these modifications in order to obtain debt classification arguably does not serve the goals of tax law. This is particularly

170. See supra notes 165–166 and accompanying text (mentioning the potential for positive and negative effects on efficiency resulting from frictions).
true when we take into account the fact that not all taxpayers will be subject to state usury laws.\textsuperscript{171} Therefore, only some taxpayers would be required to comply with state usury laws in order to obtain an interest deduction for tax purposes.\textsuperscript{172} Thus, the need to modify the terms of instruments would fall arbitrarily on only some taxpayers.\textsuperscript{173}

To further illustrate the point, consider an example involving a friction that is not a non-tax regulatory regime—the rules that govern the tax treatment of alimony. By default, alimony payments are included in the income of the spouse receiving alimony\textsuperscript{174} and deducted by the spouse paying alimony.\textsuperscript{175} However, when both spouses agree, the recipient may exclude the payments from income, and the payor does not deduct the payments.\textsuperscript{176} This tax treatment provides the individuals with a valuable tax planning opportunity, at least when the former spouses are subject to different effective tax rates.\textsuperscript{177}

\textsuperscript{171} See supra note 111 and accompanying text (giving the example that usury laws may not apply to loans made to “sophisticated” borrowers).

\textsuperscript{172} See supra note 111 and accompanying text (stating that some taxpayers are exempt from usury laws).

\textsuperscript{173} See, e.g., Schizer, supra note 39, at 1337

Rules that depend on frictions can redistribute tax burdens in random or undesirable ways. The problem is that some taxpayers may be uniquely able to avoid the friction. For instance, if securities dealers cannot supply a particular avoidance transaction, but insurance companies can, a reform may transfer wealth from dealers to insurers. Likewise, if a tax benefit is conditioned on adverse accounting, the benefit may be claimed only by firms that are relatively unconcerned about this regime. Since indifference to the friction has little to do with ability to pay, normatively comparable firms will be taxed differently.

\textsuperscript{174} See I.R.C. § 71(a) (2012) (“Gross income includes amounts received as alimony.”).

\textsuperscript{175} See id. § 215(a) (“[T]here shall be allowed as a deduction an amount equal to the alimony . . . paid during such individuals taxable year.”).

\textsuperscript{176} See id. § 71(b)(1)(B) (defining alimony as a payment that “the divorce or separation instrument does not designate . . . as a payment which is not included in gross income”).

\textsuperscript{177} The default rule would be advantageous if the spouse paying alimony were in a higher tax bracket than the spouse receiving alimony. In order to demonstrate, assume the payor is subject to a 35% tax rate, the recipient is subject to a 25% tax rate, and the amount of alimony paid is $50,000. By deducting alimony, the payor would incur tax liability that was $17,500 lower than the liability he or she would have incurred absent the deduction. At the same time, by including the payment in income, the recipient would become subject to
Furthermore, in part because of the tax treatment of alimony, a divorced couple could pay less in total tax liability than the couple would have paid while married. Imagine, for instance, that A and B were married. A earned $300,000 per year and B earned $0. As a married couple filing a joint return, ignoring the effects of any deductions, they would be subject to total liability of $74,413 in 2016. Assume they divorce and assume A pays B $150,000 of alimony per year and the parties opt for the default treatment for alimony (deductible by A and included in B’s income). As a result, each would be a single taxpayer who earned $150,000 of taxable income per year, ignoring any deductions other than the alimony deduction. As such, each would be subject to total tax liability of $35,036.75 in 2016. As a result, together, they would be subject to total tax liability that was $12,500 higher than the liability to which he or she would have been subject without this income. Thus, the aggregate tax liability of the parties under the default rule would be $5,000 lower than the aggregate tax liability that would have resulted had the parties elected out of the default rule. Moreover, both spouses could share in this aggregate benefit if the spouse paying alimony increased the amount paid in order to shift some of the benefit of the tax deduction to the spouse receiving alimony. For example, assume the paying spouse was subject to a 35% tax rate, the receiving spouse was subject to a 25% tax rate, and the parties would have agreed to alimony payments of $50,000 if they opted out of the default treatment. Retaining the default treatment and increasing the amount of the payment to $70,000 would improve the economic position of both individuals. If the payment was $50,000 and the parties opted out of the default treatment, the paying spouse would incur a $50,000 after-tax loss (he or she would pay $50,000 and would not be entitled to a deduction). The receiving spouse would achieve a $50,000 after-tax gain (he or she would receive $50,000 and would not be subject to tax on the payment). If the payment were increased to $70,000 and the parties did not opt out of default treatment, the paying spouse would incur a $45,500 after-tax loss ($70,000 pre-tax payment minus $24,500 tax savings resulting from deducting the payment from income taxed at 35%). Thus, the paying spouse’s economic position would be improved by $4,500. The receiving spouse would achieve a $52,500 after-tax gain ($70,000 payment minus $17,500 tax liability incurred as a result of taxing the payment at 25%). Thus, the receiving spouse’s economic position would improve by $2,500. For simplicity, all of the preceding calculations assume that including the payment in income (or deducting the payment) would not be sufficient to move the paying spouse or receiving spouse into a different marginal tax bracket.

178. For simplicity, this calculation ignores the effects of any available deductions. This amount is calculated as follows: 10% times $18,550 + 15% times ($75,300 – $18,550) + 25% times ($151,900 – $75,300) + 28% times ($231,450 – $151,900) + 33% times ($300,000 – $231,450).

179. For simplicity, this calculation ignores the effects of any available deductions. This amount is calculated as follows: 10% times $9,275 + 15% times ($37,650 – $9,275) + 25% times ($91,150 – $37,650) + 28% times
to tax liability of $70,073.50, which is $4,339.50 lower than the tax liability they would have owed as a married couple. ¹⁸⁰

For that reason, parties might engage in tax-motivated "friendly divorces" in order to obtain the tax benefit resulting from the tax treatment of alimony. To guard against this possibility, the Internal Revenue Code provides that a payment made to an ex-spouse cannot be alimony if the ex-spouses are members of the same household.¹⁸¹ Thus, to prevent tax-motivated, friendly divorces, the tax law adopts a "friction"—and likely a powerful friction. Namely, the parties cannot attain their tax objective unless they live in different homes.¹⁸²

In this case, the limitation is not merely a friction, but also arguably serves the underlying goals of tax law. If the ex-spouses do live in different homes, they more closely resemble a typical divorced couple in a way that is relevant to tax law. In particular, the maintenance of separate homes is consistent with treating the alimony payment as an expense of one spouse (given that the payment funds a household of which he or she is not a part) and income earned by the other spouse.

To further demonstrate the point, one could imagine a hypothetical alternative to the current rule. In particular, imagine that the Internal Revenue Code were to provide that if ex-spouses are members of the same household, a payment can be alimony only if the spouses refrain from watching television for the entire year. This restriction could also serve as a friction against tax-motivated, friendly divorces.

Under either current law or the hypothetical alternative, some couples might engage in friendly divorces notwithstanding the

¹⁸⁰ This is also less than the tax liability they would owe if they were never married. In that case, A, as a single taxpayer with taxable income of $300,000 would owe tax liability of $82,529.25. This amount is calculated as follows: 10% times $9,275 + 15% times ($37,650 – $9,275) + 25% times ($91,150 – $37,650) + 28% times ($190,150 – $91,150) + 33% times ($300,000 – $190,150). B, as a single taxpayer with $0 taxable income would owe $0 in tax liability. Thus, their total tax liability would be $82,529. For simplicity, these calculations ignore the effects of any deductions.

¹⁸¹ See I.R.C. § 71(b)(1)(C) (2012) (requiring that the payee spouse and the payor spouse are not members of the same household at the time of the alimony payment).

¹⁸² Id.
friction. Under current law, however, if the couple does proceed with the divorce, they will resemble the typical divorced couple in a way that might justify the tax treatment of alimony. In the case of the hypothetical alternative, the couple does not resemble the typical divorced couple in any relevant way. Therefore, they obtain tax treatment that is essentially arbitrary.

In summary, the ability to obtain inconsistent treatment across regulatory regimes neutralizes a potential friction and potentially facilitates tax planning. However, that result might be a lesser evil than the alternative of making the friction less avoidable. If the friction were less avoidable, some taxpayers would still engage in tax planning and bear the costs resulting from the friction. This potentially contributes to inefficiency. Furthermore, when the goals of the non-tax regulatory regime are unrelated to the goals of tax law, using the regime to create a friction produces arbitrary outcomes that do not serve the underlying purposes of tax doctrine.

C. Addressing Counter-Arguments

In the preceding Part, I have argued that a non-tax regulatory regime does not serve well as a friction against tax planning when the purpose of the regime is not aligned with purpose of the relevant tax rules, because those who engage in tax planning despite the friction will be taxed in an arbitrary manner that is inconsistent with the relevant tax provision’s purpose. Two objections might be raised in response, and each objection is discussed and addressed below.

183. Imagine a married couple that already needed to maintain separate homes because each spouse worked in a different part of the country. One could imagine this couple conceivably engaging in a “friendly divorce” because they might not view the separate homes requirement as an impediment.

184. See supra notes 174–175 and accompanying text (describing the default tax treatment of alimony as included in gross income by the receiving spouse and allowable as a deduction by the paying spouse).

185. See supra Part V.B (providing examples of potential arbitrary outcomes in such circumstances).
1. The Argument Misses the Point of Frictions

One might object to the consideration of purpose on the grounds that, conceptually, frictions are merely useful tools to hinder tax planning, and that frictions need not have anything to do with tax law or its goals. In other words, one might argue that the only thing that matters is the end result—planning around tax rules is discouraged.\textsuperscript{186}

When the friction stops tax planning, this may be true. When tax planning occurs despite the friction, then we should care about what the friction requires. Consider, for instance, the hypothetical alternative friction against friendly divorces described above.\textsuperscript{187} In


According to this theory [of frictions against tax planning], tax law relies on frictions, or nontax costs, in order to make tax planning more expensive. The goal is to deter these transactions, which are viewed as socially wasteful. Under this theory, at least with respect to the tax law, a friction serves no useful role, other than to deter the tax planning . . . . This focus on the deterrence aspect of frictions has caused scholars to generally agree upon two pieces of conventional wisdom regarding frictions. Good frictions should (1) deter tax planning rather than cause it to continue in a more wasteful fashion, and (2) not impose costs on regular business transactions.

Professor Osofsky observes that frictions can also serve a screening function. \textit{See id.} at 1058 ("I argue that frictions serve a more extensive and complex role than has been recognized previously. Although not focused on in the tax literature, frictions function first as screening mechanisms, by tracking underlying characteristics of taxpayers and imposing different costs on different groups."); \textit{see also} Alex Raskolnikov, \textit{Relational Tax Planning Under Risk-Based Rules}, 156 U. PA. L. REV. 1181, 1187 (2008) ("Forcing taxpayers to bear risk has no connection to income measurement or any other fundamental goal of our tax system. It is just a friction—a cost imposed on taxpayers to prevent them from escaping tax, primarily on capital income."); Shaviro, \textit{Economic Substance, supra} note 165, at 222

From this perspective, economic substance is just a tool for accomplishing aims that have little to do with how one might define it as a matter of internal logic . . . . [O]ne might as well condition favorable tax consequences on whether the taxpayer’s chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool’s Day, if such a requirement turns out to achieve a better ratio of successful deterrence to inducing wasteful effort in meeting requirements that are pointless in themselves.

\textsuperscript{187.} The hypothetical alternative involved imagining that the Internal Revenue Code were to provide that if ex-spouses are members of the same household, a payment can be alimony only if the spouses refrain from watching
cases in which it prevents taxpayers from engaging in tax-motivated divorces, the arbitrariness of the rule arguably does not matter. However, in cases in which the tax-motivated divorces continue, an arbitrary friction leads to arbitrary outcomes.

2. Purpose is Indeterminate

One might also object to the consideration of purpose based on the view that purpose is indeterminate and, therefore, cannot provide a useful guide regarding whether a friction is or is not desirable. To take the example of the determination of whether an instrument is debt or equity for tax purposes, treating debt differently from equity does not serve any clear underlying purpose. Therefore, we cannot judge whether a friction serves or undercuts the underlying purpose given that there is no such thing.

To clarify, I am not using the terms “purpose” of tax law or “goals” of tax law to refer to underlying normative goals. I acknowledge that what I have labeled “purpose” or “goals” might be labeled, more accurately, as existing tax law doctrine or consistent application of precedent. For instance, when judging whether it is appropriate to treat an instrument as equity for bank capital requirements, but debt for tax purposes, I have argued above that this determination depends on whether or not the holder of the instrument has a definite right to payment so that the instrument is properly classified as debt for tax purposes. I am not asserting that classifying an instrument differently when the holder has a definite right to payment furthers a fundamental, underlying policy of tax law. Rather, I am arguing that the courts have held that a definite right to payment is the defining
television for the entire year.

188. See, e.g., Weisbach, Line Drawing, supra note 93, at 1638

As with the realization requirement, one cannot use the underlying purpose behind the debt-equity distinction to draw the line [between debt and equity] . . . . Given this lack of normative content for the corporate tax, it is difficult to determine the appropriate debt-equity boundary by reference to the underlying goals.

189. See supra Part IV.C (observing that existing tax doctrine provides that an instrument is debt for tax purposes when the holder has a definite right to payment).
characteristic of debt. Therefore, given the tax law that exists, instruments should be classified in a manner that is consistent with this doctrine.

One might respond that doctrine can always change. That is certainly true; however, if a change to tax doctrine is desirable, then for reasons of transparency, it ought to be initiated directly, rather than indirectly by requiring taxpayers to make changes for purposes of other regulatory regimes. For example, consider the illustration above regarding state usury law and tax law. Imagine the regimes were linked so that an instrument could only be classified as debt for tax purposes if the instrument would be classified as debt under existing tax doctrine and also is classified as debt for state usury law purposes. Under this new regime, some taxpayers that were subject to state usury laws might modify the terms of instruments that would have been debt for tax purposes without this change. In particular, taxpayers might reduce the yield on the instrument to comply with state usury laws and make other changes (such as providing security for the loan) to make the reduced yield palatable to the instrument’s holder. Certainly, these changes (a reduced yield and additional security) make the

190. Furthermore, in some cases, existing doctrine perhaps should change if it does not best serve underlying policy goals. See, e.g., Weisbach, Line Drawing, supra note 93, at 1643–44

The typical approach to line drawing is platonic. It searches for the essential meaning of words, such as corporation, partnership, debt, equity, selling, or holding, and draws lines accordingly. For example, . . . the current doctrine distinguishing debt and equity looks to the typical features of “debt” and “equity.” The platonic approach fails as a general method of drawing lines. The platonic or essentialist notions contained in doctrinal rules are not tied to values that a tax system should promote. Tax doctrines do not, for example, draw lines that necessarily make the system more equitable, more efficient, or more administratively feasible. Moreover, platonic approaches cannot be defended on pragmatic grounds because the words themselves do not have readily accessible meanings. The effect is that the platonic approach does not make the system more certain.

191. See supra Part IV.B (discussing circumstances in which an instrument could be classified as debt for tax purposes, but equity for state usury law purposes).

192. See supra Part IV.B (discussing how, under such a regime, taxpayers who wanted to issue an instrument that was treated as debt for tax purposes might reduce the yield on the instrument to comply with state usury laws and make other changes so that the reduced yield was acceptable to the instrument’s holder).
EXPLOITING REGULATORY INCONSISTENCIES

instrument more debt-like. However, if courts did not think the instrument was sufficiently debt-like without the changes to obtain classification as debt for tax purposes, then they ought to reach that conclusion directly, holding that an instrument with the original features was equity for tax purposes. Such an approach would be more transparent, and it would apply across the board to all taxpayers and not merely to taxpayers who needed to modify the terms of an instrument to comply with state usury laws.

VI. Conclusion

Sophisticated parties frequently structure their transactions to simultaneously obtain beneficial treatment under multiple regulatory regimes, sometimes by designing a given transaction so that it is classified differently for purposes of different regimes. For example, a bank might issue an instrument treated as debt for tax purposes, but categorized as equity for purposes of capital requirements imposed by bank regulators.

Inconsistency across regulatory regimes is not necessarily problematic. Different regulatory regimes can serve different purposes so that, in some cases, inconsistent treatment across the regimes is perfectly consistent with the goals of each regime. Moreover, when the regimes serve different purposes, requiring consistent treatment across the regimes could undercut the goals of one or more of the regimes. For instance, requiring that the tax classification of a given transaction must not differ from its classification for purposes of some other regime, in order to impose a friction against tax planning, could undercut the goals of tax law and result in arbitrary tax outcomes.

193. See supra Part II.A (presenting examples of inconsistent treatment).
194. See supra Part III (arguing that inconsistency is not necessarily problematic).
195. See supra Part III (noting that inconsistency may arise from the fact that different regimes serve different goals).
196. See supra Part III (noting that if different regimes serve different goals, then it might be necessary to classify a transaction differently for purposes of each regime to avoid a true inconsistency).
197. See supra Part V.B (providing examples of how requiring consistent treatment could produce arbitrary results).
In other cases, however, inconsistency could represent a byproduct of incorrect classification by one or more of the regimes.\textsuperscript{198} Even in such cases, the inconsistency itself is not what is objectionable.\textsuperscript{199} Rather, the defect is simply the failure of one (or more) of the regimes to classify the transaction in a manner that best serves the goals of that regime.\textsuperscript{200}

\begin{itemize}
\item \textsuperscript{198} See supra Part IV (illustrating that inconsistency could be a byproduct of a failing in one or more regulatory regimes).
\item \textsuperscript{199} See supra note 142 and accompanying text (explaining how the problem in such a case is not inconsistency but is instead a failing by one or more of the regimes).
\item \textsuperscript{200} Id.
\end{itemize}